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National Tax Journal

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THE ROLE OF ECONOMICS IN FEDERAL TAX ADMINISTRATION

WIRTH F. FERGER *

IT has long been recognized that consideration of economic principles is vital in the field of tax policy and tax planning. Even though these principles may often be honored in the breach, their pertinence is universally granted. What innovator would dream of presenting his tax program for public consideration without an adequate—in his opinion—demonstration of its perfect harmony with the true principles of economics? The United States Treasury Division of Tax Research bears testimony to the official recognition of the place of economics in tax policy.

In the realm of tax administration, however, only in recent years has the economist been called upon to supplement the work of the accountant, the engineer, and the lawyer. As might be expected, experiment preceded any definite adoption of economics as a recognized tool in collecting the taxes, and the process of evolution still continues: new problems continually arise

where economics can make a contribution to the practical every-day administration of the Bureau of Internal Revenue.

The basic reason for recourse to the new discipline is the increasing scope and complexity of the tax statutes. The discussion which follows will, it is believed, illustrate some of the reasons for this increasing scope and complexity, which seem to lie in an attempt to plug avoidance loopholes and make the impact of tax burdens more discriminative. The very terms "unjust enrichment tax," "excess profits tax," and "fair and just amount representing (normal) net income" indicate the purpose to have taxes as highly discriminative as possible, in the true meaning of that word, the discernment of differences. Tax law continually strives for an ever more careful perception and appreciation of fine distinctions, a recognition of true distinctions amidst superficial similarities. Where these fine distinctions appear in the field of economic concepts, as in making a tax or a tax refund depend upon the possible shifting of a burden of an earlier imposed tax, it is clear that the economist must

* The author is head of the Business and Industrial Research Division, Bureau of Internal Revenue, United States Treasury Department. The views expressed in this article are those of the author and do not reflect official policies of the United States Treasury.

aid the accountant and lawyer in applying the statutory provisions. Or where the tax administrator must measure the normal pre-war income of a corporation under hypothetical conditions, the resulting problems go far beyond the scope of accounting techniques. Nor do cases decided by the courts before the emergence of the new concepts furnish much precedent for the lawyer, particularly when the hypothetical conditions are suggested as goals in the taxing statute rather than defined in detail.

This paper will use three examples to illustrate the contribution economics is making to more effective tax administration.

Processing Tax Refunds

The experimental phase of economics in modern tax administration began with the situation created by the invalidation of the Agricultural Adjustment Act and its processing taxes by the Supreme Court on January 6, 1936. This decision paved the way for a new principle of taxation, involving both tax collections and tax refunds. Prior to that time the tax administrator had not needed to bother with the question of who bore the burden of a tax. He collected the taxes imposed by Congress as best he could, let the taxpayer find the money where he might, and let Congress or the tax planner worry about the shifting and incidence of the taxes paid. But with the invalidation of the processing taxes, there was a fund of nearly a billion dollars, collected over a period of two and one-half years from a relatively small group of processors of selected farm products—flour mills, meat packers, cotton textile mills, sugar refiners, and so on—who, in general, had acted merely as collectors of the

taxes paid to them by consumers, but who, under existing law, were entitled to a full refund of the taxes on application. It seemed inequitable to levy new taxes to collect the money to make the refunds to the processors, just because they were technically the taxpayers who signed the checks in payment of the invalid processing taxes.

There was also the companion problem of either collecting for the Government or allowing processors to keep the quarter of a billion dollars representing processing taxes for several months prior to the invalidation of the statute—taxes which were not yet due to be paid, even though collected from consumers, or funds paid into escrow under court order by hundreds of processors who obtained court injunctions against the collection of the taxes by the Government. These funds, never in the Federal Treasury, were returned to the processors by the courts following the Supreme Court decision. Those processors who had shifted the burden of taxes had no more equitable right to keep these impounded funds than to receive a second reimbursement of taxes paid to the Government.

The inequity in both cases was especially glaring because of the general recognition that the processing taxes were intended to be indirect taxes. This intention was evident in several elaborate provisions of the Agricultural Adjustment Act itself, such as the section putting compensating taxes on competing articles like paper bags and towels, and the section laying special import duties on competing goods. There were likewise provisions in the Act that made sense only on the assumption that the processing taxes were added to prices—export drawbacks and

tax refunds on goods going into charitable uses, for instance. The data of the Department of Agriculture showed that in general the intentions of the act in this regard had been realized in practice. Certainly no general refund of the taxes could be justified.

But it was not certain that in the case of all of the commodities involved the processors had actually been able to pass on to others the full burden of the taxes in line with the intentions of the act. In the case of tobacco products, for instance, the prevalence of customary prices for cigarettes and chewing tobacco had made it unwise for some manufacturers to raise prices as a result of the processing tax; backward shifting was highly improbable, and it was by no means certain that sufficient economies in manufacture could be achieved to balance the tax expense. More important, it was believed that the courts would have invalidated any attempt to defeat the refund of the amounts paid in as taxes or to collect the amounts retained by processors, on any such general grounds as the intent of the Agricultural Adjustment Act to impose indirect taxes or a demonstration of the economic theory of the probability of their general shifting. Legally, a tax is a payment by the person on whom the tax is laid in the first instance, and, in the absence of strong overriding considerations, he is entitled to the refund of a tax illegally collected.

In the case of sales taxes on cosmetics and automobile accessories erroneously collected, the principle had been well established that Congress could properly lay down the rule that a taxpayer could receive a refund only after showing that "such amount was not collected, directly or indirectly, from

the purchaser or lessee," or that he had himself made a refund to the purchaser or lessee. The same principle was applied in the amendments to the Agricultural Adjustment Act of August 24, 1935 (five months prior to its invalidation), when the issue of the validity of the taxes was seriously raised by the invalidation of the National Recovery Act. This provision was immediately subjected to legal attack, as being an impossible burden of proof in the case of processing taxes, and undoubtedly influenced many judges in granting hundreds of injunctions against further collection of the taxes. One judge expressed his feeling in these words: "I cannot figure out how a processor, assuming that he sells the pork and sells it for more than the amount of the processing tax would ever be able to prove he did not pass on the tax. I have not been able to figure that out. I do not think he could. I do not think as a practical proposition he could, so I think those are just words, just words that mean nothing."

As a matter of fact, the experience with the cosmetics and automobile accessories sales taxes furnished no precedent with respect to the practicability of a demonstration of the absorption of a processing tax burden by a taxpayer. True, with respect to the sales taxes the Supreme Court held that "If the taxpayer has borne the burden of the tax, he readily can show it; and certainly there is nothing arbitrary in requiring that he make such a showing." But there the legal shifting of the tax burden depended merely upon the manner of billing the customer, and whether the manufacturer had minimized the tax by applying the tax rate to the net amount of the sale price instead of the gross

amount billed to the customer. The question involved the shifting of a sales tax in a technical sense rather than the shifting of the real economic burden of a tax which constituted a cost of production. Quite properly, then, processors who had paid the processing taxes whose validity was being attacked challenged the Government to suggest how the proof of the absorption of the tax burden could be made.

What was required, following the invalidation of the Agricultural Adjustment Act, was a provision requiring a demonstration by a processor of his equitable right to a refund, or to the nonpayment of impounded taxes, coupled with a formula showing how such a demonstration could reasonably be made. Such a formula was necessary, it was believed, not only to aid in the defense in the courts of the basic requirement of proof of tax burden bearing as a condition of tax refund (or nonpayment of impounded taxes), but such a formula was necessary also in the practical administration of these provisions—in guiding the preparation of refund claims by processors and their examination by the Bureau of Internal Revenue. Here was a challenge to economics to show that in the field of tax shifting it could do more than theorize on the general tendency of certain types of taxes to be shifted or absorbed by the taxpayer, under various assumed conditions, and to propose a formula that would meet the requirements of "due process of law" in the courts.

Fortunately agricultural economists, both within the Department of Agriculture and outside, had been analyzing the operations of the various processing taxes through the continuous study of the margins or spreads of processors—

the difference between the unit cost of the raw material, say wheat, and the value of the resulting products, flour and the milling by-products. These analyses clearly showed that in most instances the margins widened on imposition of the taxes, and similarly narrowed on their removal. In some cases, cotton, for instance, the influence of other factors was clearly evident, such as the increase in labor costs on adoption of the N.R.A. industry code just prior to the imposition of the taxes. This analysis of cost-price margins seemed to furnish an adequate basis for the formula desired.

The formula took the form, as applied to refunds, of a comparison of the average processing margin of the taxpayer per unit of commodity during the whole of the period of his tax payment, with the similar unit margin for the two years prior to the imposition of the tax and the six months following its removal.¹ A failure of the margin to widen during the tax period by an amount equal to the tax was taken as *prima facie* evidence of the absorption of the tax to the extent of the deficiency: similarly a widening of the margin by the full amount of the tax or more indicated its complete shift. Either the claimant or the Commissioner of Internal Revenue could rebut this *prima facie* determination by showing that some other circumstance than the processing tax—higher labor costs, for instance—helped to explain the facts found.

¹ For a more detailed and comprehensive treatment of this legislation, with appropriate citations, refer to the writer's "Windfall Tax and Processing Tax Refund Provisions of the 1937 Revenue Act," *American Economic Review*, XXVII (1936), 45-60. See also "The Measurement of Tax Shifting: Economics and Law," *Quarterly Journal of Economics*, LIV (1940), 429-454.

The use of this formula does not imply the acceptance of any particular economic theory of tax shifting: an industry may be monopolistic or competitive; it may be static, dynamic or senescent; the demand for its products may be elastic or inelastic; the tax may be shifted forward, backward, or not at all—the factual analysis is still applicable. In the initial phase of the simple comparison of margins, it is implicitly assumed that the industry is one of constant costs: decreasing consumption as the result of a possible shift of the tax is assumed to have no effect on unit costs. In the rebuttal phase, however, any demonstrated change in unit costs due to this or any other cause is taken into account. Thus, the only assumption is that the price policy adopted by the management—be this policy one of price adjustment or price stability—represents a rational reaction to the situation facing the management. For beyond question the problem of tax shifting is a problem of prices and price relationships.

Such methods, of course, would not be quantitatively perfect in measuring tax shifting. No final and definitive estimate can ever be made of what *would have been* in the tax period except for the single factor of the tax. Fortunately, however, taxation is recognized as a practical matter not requiring such precision. The legal requirements necessitated one important compromise with theory and equity in the provisions for the recapture of unpaid taxes—the unjust enrichment tax. Here the provision took the form of an income tax on the *income* from the nonpayment of the taxes. It is quite clear that a tax may be shifted even though the tax-

payer may be operating at a loss: he might have operated at a loss in the absence of the tax. But it was felt not advisable to attempt to impose a tax on hypothetical income from a particular source or during a few months of a fiscal year when the taxpayer had a net loss, or a net income smaller than the tax, for the whole year. Thus the tax was imposed on the taxpayer's net income for the year, *to the extent* that it was attributable to the nonpayment of processing taxes whose burden had been shifted. The rate of tax was put at 80 per cent instead of 100 per cent. Owing to these provisions some of the withheld taxes were not recaptured by the Government, even though their burden had been shifted by the processors.

Following the enactment of these provisions by Congress in the Revenue Act of 1936, problems of administration began, and they were by no means simple, particularly in regard to the rebuttal arguments. Especially difficult was the treatment of the assertion that in some cases it was an increase in demand that caused the increase of the margin during the tax period, instead of the shifting of the tax. Both taxpayers and the Government called in economists to marshal the evidence and argument and to serve as expert witnesses in the court cases where the issues were adjudicated. Taxpayers generally went to the universities and trade associations for their economists; the Treasury made arrangements with the Department of Agriculture for the part-time services of a group of commodity experts and economists to aid in the administration of these provisions. These economists for both parties brought all the tools of their craft, including highly technical

statistical methods, into the contest. In at least one series of crucial cases the technical economic issues were settled by the economists and commodity experts around the conference table, with lawyers excluded by mutual agreement.

Since this episode in Federal taxation is now practically complete, with all the cases disposed of by the Bureau of Internal Revenue and most of those appealed to the courts likewise finished, the episode furnishes the best example to date of the role that economics can play in tax administration. The limits of the present paper do not permit any detailed consideration of the manner in which these provisions fared in the courts. (Here is a nice master's thesis subject for some student.) Briefly, it can be said that the directness of the economic approach has brought the main features of the refund and unjust enrichment tax provisions through the battles in the courts unscathed. From the drafting of the original legislative proposals, through consultative advice in the stage of case-by-case administration, on to advising trial attorneys during the litigation stage, economics has been able to make its contribution. It is no exaggeration to say that this episode of extracting the greatest degree of equity from the situation brought about by the invalidation of the processing taxes by the Supreme Court would never have existed but for the contribution of economics.

One final point deserves mention. In his contacts with claimants, administrators, and attorneys, the Government economist remains a scientist, and does not become a partisan. He does not control the policy or position taken by the Government, since he is only an adviser to the responsible administrator

and attorney. But he does control his own counsel and his expert testimony. Since the courts will presumably rectify any erroneous actions of the administrator, the economic adviser best serves by giving unbiased, expert counsel. To illustrate in another field, one of the papers written by the present author, mentioned above, has been widely quoted by attorneys for refund claimants as well as the Government. It has also been cited in several court decisions, once to disprove the theory held by a lower court.

Excess Profits Tax Refunds

The second example which will be used to illustrate the contribution of economics to tax administration is the "general relief" provisions of the war-time excess profits tax statute, the well-known section 722 of the Internal Revenue Code.

Under these provisions, enacted in 1942 with retroactive effect, any corporation that has paid excess profits taxes in any year, and that believes that its base period (1936-1939) average net income was an "inadequate standard of normal earnings" for comparison with the war years, can base a claim for refund of its tax upon a demonstration of a *hypothetical* normal base period income.²

The base period abnormality may lie in a physical interruption such as a strike, fire, or flood, or an economic disturbance, either peculiar to the tax-

² In the present paper it will be necessary in the interest of brevity and clarity in some cases to use inexact and incomplete language, and to oversimplify the illustrative material. For example, the base period is not the four years 1936-1939 for every corporation; the period may be as short as 37 months or as long as 59 months, depending on the fiscal periods used by the corporation. This is not a treatise on the technicalities of the excess profits tax, but a suggestive treatment of selected aspects.

payer or general in its industry, if temporary and unusual. The taxpayer corporation may show its base period profits experience to be subnormal because of a variant cycle of profits characteristic of its industry, or a pattern of sporadic high profits years inadequately represented in the base period. The taxpayer may show a change of character in business, such as an increase in capacity, a change in management, or introduction of a new product or process during or immediately prior to the base period, that renders prior earnings unrepresentative of the changed taxpayer. Finally, certain corporations formed after the base period, and filing their tax returns on the invested capital credit basis, can compute hypothetical base period earnings, seeking a higher credit against war-time income subject to high excess profits tax rates. In short, the aim is to ascertain the *normal* income, under base period general economic conditions, of a corporation of the character that stood on the threshold of the war period.

When the Bureau of Internal Revenue in 1943 faced the problem of examining the refund claims of several thousand corporations under these provisions, it quickly recognized the need for again supplementing its staff of auditors and attorneys, to let the economists help solve some of the problems presented. Tax auditors had never before been called upon to determine the *normal* income of a corporation, much less the normal income under a combination of real and hypothetical conditions. Accounting and engineering techniques alone were inadequate. Taxpayers, likewise, when it was found that allegations of abnormality had to be supported by adequate facts and analy-

sis, turned to economists and statisticians to provide substance to refund claims. With the background of experience with economists in the determination of the unjust enrichment tax and processing tax refund provisions, the Bureau of Internal Revenue set up a small economic division within the Income Tax Unit, primarily to give advisory services on these refund problems. It is significant, too, that when the Excess Profits Tax Council was later created to centralize responsibility within the Bureau for the interpretation and administration of the refund provisions, economists were included, although in a minority to accountants and lawyers.

Economists, of course, had themselves never faced the precise problems involved in estimating the normal income of a specific corporation under unreal conditions: in fact, the problems are not strictly economic in nature. The task is to put flesh on a statute designed to meet a difficult practical situation, a skeleton statute with some quite arbitrary features, such as the predating of certain events in the operations of the taxpayer corporation. Nevertheless the disciplines and techniques of economics and statistics, when applied with discernment, common sense, and constructive imagination, furnish helpful guides. The only alternative is a crystal ball, and there is sometimes a temptation to use it as a supplemental tool!

The most pervasive problem is the estimation of constructive base period income for a corporation that underwent a change in character during or shortly prior to the base period, or even following the base period (in the case of increased capacity) in consummation of a commitment made during the base

period, giving rise to a higher standard of normal earnings. By assuming the change occurred two years earlier than it actually occurred, the statute grants the corporation this additional period of shakedown of plant and management and exploitation of its market, under base period conditions, to demonstrate what the earning capacity of the changed corporation would have been by the end of the base period. What correlative assumptions should be made, in judging this earning power, when the qualifying change in character is predated two years? Could the corporation have sold more product if it had made the change earlier? Should capacity operation of an enlarged plant be assumed? Should actual sales prices be presumed to apply to the expanded output, or should the added production be regarded as necessitating sales at a lower price in view of the demand existing in the base period? If so, how much lower? Can the elasticity of demand be measured or estimated? Or, on the contrary, should the *anticipated* demand, which called forth the added capacity, be constructively assumed to have been present in the base period as a necessary concomitant for constructing the "normal" income to be realized from the added capacity?

Obviously the answers to these questions depend upon the situation in each case. Was the taxpayer's industry expanding or static? Was the taxpayer consistently capturing a larger share of the market, or merely keeping up with its industry? Was the taxpayer's output a substantial portion, or a microscopic part of the total production of its industry? Was the expansion of production during the base period a true growth in the industry, or merely a

part of the recovery from the depression of the 1930's? Were the taxpayer's competitors expanding, or planning to expand, at the same time as the taxpayer? If so, would the added production cut the profits of all? Or is it improper to consider the prospective actions of other producers in dealing with the constructive base period income of a given taxpayer?

Having determined that the taxpayer's level of base period earnings would have been higher had the change in character been made two years earlier, as provided by the statute, how *much* higher would they have been? Would the growth have continued at the same rate, or at the same percentage rate, as in the last year or two of experience? Or would the increase be at a declining rate within two years? We know that eventually the increase must taper off, but when? The actual experience of growth after 1939 cannot be used as a guide because the reconstruction must presuppose base period economic conditions. And even the production, or sales, or profit experience of the taxpayer during the base period does not, without adjustment, show the past growth due to a change in character. Since in most industries 1938 was a year of sharp depression, an improvement from 1938 to 1939 does not correctly measure the growth due to the change in the corporation's operations: first, there must be a correction for business conditions in the industry.

These questions and comments suggest the breadth of the considerations that are vital to a realistic reconstruction of normal base period net income in the case of a change in character. The approach of economics is the identification of the crucial factors of change, on the one hand, and the relatively

static elements, on the other. From the facts at hand, and those that can be found, the few that contain the key to the reconstruction of normal earnings under the hypothetical conditions postulated are then isolated. A study of past experience of either the taxpayer or comparable concerns, or both, generally indicates which elements are related to the changes hypothesized, and which are independent, and thus static. In the example referred to above of expanded capacity, does experience indicate a relatively fixed pattern of consumer purchases (demand curve), so that an increased volume of sales could be made only at falling prices, or was there an expanding market (a shift of the demand curve to the right)? Are changing unit costs of production or marketing implicit in the expansion of capacity and the scale of operations resulting? Or can these variables all be reduced to a constant net profit per unit, or a slowly changing profit per unit?

Experience has shown the extreme caution necessary in approaching the problem of reconstruction of base period net income by means of minutely detailed cost accounting schedules. This method starts with an accepted figure for expanded volume of production and an assumed price, and estimates each item of production, marketing, and overhead cost according to some formula of fixed, variable, or mixed costs, based on past experience. There have been instances of this technique where the outline of steps is unassailable, and where the details in each step are apparently reasonable, but where the end result is fantastic. The trouble is that a slight margin of error in a gross income or expense item is magnified into

a much higher percentage error in the resulting net income. It is unsafe to count on such errors compensating for each other. It has been found generally to be more satisfactory to follow informed economic and statistical judgment in analyzing the dynamics of the position of the individual taxpayer in relation to the environment of its industry and its market, and to base reconstructions upon simpler computations where the implicit assumptions stand out clearly.

Consider next the case of an industry with an alleged cycle of profits varying materially in length and amplitude from the general business cycle, causing a depression in this industry in the base period when general business was, by statutory definition, normal. When is a business or an industry depressed? When base period average earnings are smaller than the 1926-1929 average? When less than a long period average, excluding deficits? In connection with the cycle problem, normal profits would seem to be those over a long period, including good times and bad in their actual proportions, but excluding abnormal periods such as war booms and postwar depressions. A cyclical normal, furthermore, should recognize and adjust for any long-term growth or decline in the industry and in the taxpayer's business, and would not necessarily be represented by a straight arithmetic average of profits in absolute amounts.

Granted that a taxpayer and its industry were depressed in the base period, how can it be determined that this was due to a variant cycle? Obviously the determination of a *material* variation in length and amplitude, as required by the statute, is in the final analysis a

matter of judgment. Amplitude would seem to be of relatively little evidentiary value, since the divergence of a single firm and a single industry from general business may represent merely the dispersion in any series of data around its average, the general business cycle being merely the aggregate profits experience of all business. The identification of a difference in length of the cycle of an individual industry has generally been approached through the graphic method, noting the timing of the major and minor turning points compared with general business. Profits are the business data to which attention is directed first, last, and always, but other elements such as sales volume or price fluctuations may be noted in the study of the causes for profits behavior. If sales volume is "normal," it is unlikely that any abnormality of profits would be due to a variant cycle. Again, if industry profits data are not reasonably available, other data may be acceptable in analyzing the cyclical aspects of a given industry. Any *material* difference in length of the cycle should be clearly evident in the annual data generally employed. Attention is usually focused primarily on the modern period from about 1922 (following the post-World War I boom and depression) through 1939, the end of the base period. If the statistical evidence is inconclusive, it may be supplemented by analysis of the economic relation of the industry in question to other industries and the general economy, to support a reasonable expectation of a variant cycle.

It seems axiomatic that there cannot be many industries with cycles materially at variance with general business. Not only would such heterogeneity in-

validate the very concept of "the general business cycle," but our knowledge of the interdependence of the various segments of the economy eliminates the possibility of numerous exceptions to the rule of substantial similarity. It is likewise inconceivable that any industry dependent on mass demand could have a variant cycle. The principal variant cycle industries have been found to be those with some intimate kinship to the building or construction industries, where the long cycle has been generally recognized by economists.

A closely related set of excess profits tax problems on which the help of economists has been sought are those involved in the determination of the amount of abnormal income realized in a taxable year which is attributable to exploration or developmental expenditures in prior years, as provided in a part of section 721. How is one to split the income actually realized in a war year, and allocate some to other years? The *principle* of discrimination is clear. To illustrate, suppose one producer using standard processes turns out a thousand units during the year (an excess profits tax year) at a net profit of a dollar a unit. Another producer using his own patented processes developed in prior years likewise turns out a thousand units, but at a profit of two dollars a unit. Prior to the war each made profits of a dollar a unit. Obviously it would be inequitable to impose an excess profits tax only on the inventive producer on the theory that his increased profits are war-induced. The excess profits taxes should be discriminative, and take account of the actual though perhaps subtle differences between the two cases. This is the reason for the provision freeing from the excess profits

tax that part of wartime income attributable to exploration or developmental expenses in prior years.

In actual practice, of course, it is not so easy to segregate such income as in the illustration just given. Wartime profit is usually the result of a combination of several factors, including manufacturing and selling, the income from which obviously stems from the year in question rather than from exploration or invention in a prior year. Occasionally it is simple to separate out that part of the income attributable to exploitation of the invention, as when the invention is also licensed to other producers in arm's-length transactions. In this case the royalty equivalent measures the income attributable to the invention.

But even in this case all of the royalty equivalent on current production may not be attributable to earlier years if, and to the extent that, economic conditions in the war years have brought about an increased demand for the product. It is in the determination of the demand factors particularly that the aid of economics has been sought.

It is interesting to note that the two provisions of the excess profits tax statute discussed above are not mutually independent. One of the bases for claiming a hypothetical base period net income higher than actual is the development of a new product or process during or prior to the base period which resulted in a higher standard of normal earnings than the actual average of the base period years. If relief is granted on this basis, computing constructive income to include the normal income with the use of the new product or process, then it is apparent that the wartime income must not also be adjusted

to exclude that attributable to the change. The taxpayer cannot eat his cake and have it too—build up base period income for the new product or process, and eliminate the resulting earnings from taxable wartime income. Again the principle is clear; the difficulty comes in determining the facts in complex cases, putting these facts in proper perspective, and giving each its proper weight.

LIFO Inventory Method and Index Numbers

The final example to be cited concerns a specialized problem that recently faced the Bureau of Internal Revenue, touching the techniques of both accounting and economic statistics. The example is on a much more limited scale than those previously cited, but it illustrates just as well the role of economics when new problems, new techniques, and new principles confront the administrator. In this case the problem arose through the adaptation by economists of index number techniques to the needs of accounting. It concerns the adoption of the "last-in-first-out" inventory method by many department stores in 1942.

In any period of rapidly changing prices such as the last seven years, the problem arises of what material costs should be applied to the goods sold. In a period of rising costs, meaning an inflation of inventory values, the apparent profit realized during a given year will depend partly on whether current sales are charged with current stock costs or with the actual costs of the stock acquired at earlier, lower prices. In theory, if an inventory of a given quantity of goods is constantly necessary to continue in business, there is much to

be said for the view that profit figures should not reflect the *unrealized* profit or loss from inflation or deflation of prices of goods in inventory. This means keeping the inventory on the books at constant costs, to the extent that similar fungible goods are maintained in the inventory. This is the idea in the last-in-first-out, or LIFO, inventory method.

This procedure has been allowed by statute in Federal tax accounting for several years. The Treasury Regulations have permitted its use, however, only in those cases where the taxpayer's inventory records are kept in terms of specific fungible goods, allowing the direct comparison of unit costs at the beginning and end of the year. Such is the case, for instance, for manufacturers with inventories of fine gold or copper, or cattle hides, or cotton of given grades and qualities.

✓ In the late 1930's there was a good deal of interest in the possible use of the method by retail stores, and in particular by department stores. But the use of the retail inventory method, under which all inventory records are kept in terms of retail values by departments, precluded conformance with the requirement of the Regulations of identifying actual cost of each type of item. Challenging these regulations, a group of department stores, through the National Retail Dry Goods Association, arranged a test of the matter in the courts by filing their returns on the LIFO basis. For this, however, it was necessary to have a series of price index numbers to show the average price changes in the goods in the various departments of a store. Although a very few stores constructed their own indexes, most of the stores joined in

calling in the statisticians of the National Industrial Conference Board, a private research agency, to design and construct a set of departmental index numbers, on an over-all national basis.

The construction of price indexes is, of course, a highly technical matter, involving the mathematical principles of the choice of the proper formula, the theory of sampling in order to select from the hundreds of articles in each class a manageable number of articles to be priced, the determination of the proper weights to be employed in averaging these prices, and, in a period such as the last seven years when many important items were unobtainable, the problem of substitution of commodities. Always there is the problem of assuring accurate reporting of data, involving the choice of reporters, and requiring a sufficiently careful description of the articles to be priced so that strict comparability is maintained from year to year. When the test case came to trial before the Tax Court, there were two primary issues. In addition to the strictly legal question of the propriety of the Commissioner's Regulations requiring identification of individual items, certain questions concerning the appropriateness of the price indexes used were involved. Had sufficient care been used in their preparation? Can reliable data be obtained by mail questionnaires, filled out by store buyers unacquainted with the statistical problems involved? Was the sample of items in each department adequate? Was the sample of reporting stores an adequate and representative one? Are price changes in different cities, and in different types of stores, sufficiently similar to warrant the use of a single set of national indexes by individual stores throughout the country? Are the inventories of different

stores likewise sufficiently similar in their composition to insure that such indexes are representative? And finally, as a matter of policy, should the Bureau of Internal Revenue accept such indexes prepared by a private organization, no matter how reputable, when the secrecy of the data maintained by the organization precludes answering such questions as these? If indexes prepared by one reputable organization were accepted on faith, could a Government agency differentiate between it and any other private agency, or must it accept without question the results of all such studies presented to it on behalf of other trades? It is easy to understand, I think, why the Government attorneys assigned to prepare this case for trial came to economists with a plea for help.

To skip a large part of the chronology, the decision of the Tax Court was favorable to the department stores on the legal point, holding that they have the right to employ the LIFO inventory method along with the retail method, and implying sanction of the use of price indexes.³ But on the economic questions, the court made no decision as a matter of precedent, holding that, faced with the primary decision, the Commissioner should have an opportunity to study the matter of what price indexes were appropriate, and draw up regulations embodying the principles decided upon.

This decision left the Commissioner with a neat dilemma, in deciding whether to acquiesce in the decision or appeal it to the higher court and in planning the administration of the measure in case of acquiescence or defeat on appeal to a higher court. It seems clear that price indexes prepared

by each store on the basis of the data on prices and quantities of goods in its inventory would be in theory the most accurate and reliable indexes for adjusting prices. This would also accord with the general accounting principle that income is computed from data on the company's own books, rather than data from some other source. But with the highly technical statistical problems involved, and the absence of trained statisticians in or available to the stores, it is by no means certain that the actual results would equal the promise of theory—the prospects are quite the contrary. Just as disturbing from the point of view of the Commissioner was the appalling prospect of having to audit these hundreds of sets of price indexes. Was the use of LIFO by retailers administratively practicable?

Here economists faced the practical problems of administration and suggested study of a possible compromise in the form of a set of index numbers to be prepared by a public body, the United States Bureau of Labor Statistics, for this special purpose, but as a by-product of its regular collection and publication of its well-known data on consumer prices. If found to be suitable, these official indexes could be accepted by the Bureau of Internal Revenue without audit. The prices for the consumers price index are collected on the spot, in person, by trained agents working from elaborate statements of specifications, to assure comparability year after year. The B. L. S. statisticians have the benefit of long experience in solving the problems that inevitably arise in adapting such indexes to changing conditions. The crucial questions were whether the agency had collected data in the past on a sufficient number of commodities ade-

³ Hutzler Brothers Company, 8 T.C. No. 3.

quately to cover a department store, department by department, and whether a single set of indexes, or even sectional indexes, would represent the price movements in individual stores of different types, in various cities, with sufficient accuracy for practical purposes.

Arrangements were made for representatives of the American Retail Federation and the Bureau of Internal Revenue to work on the problem with the experts in the Bureau of Labor Statistics, and after several months of investigation and experiment it was agreed that a practicable set of indexes could be prepared for past years, and improvements made in the future, that would give results sufficiently accurate for practical purposes. This conclusion was influential in the decision of the Commissioner of Internal Revenue to accept the decision of the Tax Court on the main issue without appeal to the higher courts. Thereupon the Bureau of Labor Statistics proceeded with the construction of the special indexes, the additional costs being borne by the trade association, and a sample of stores co-operated to the extent of submitting their annual inventory data to the B.L.S. for the purpose of setting up the weights. No one pretends to great precision in the application of such general indexes to individual stores, but a solution to the staggering administrative problem presented by the court decision, satisfactory both to taxpayers and to the Bureau of Internal Revenue, has re-

sulted. Revised regulations have been promulgated, the indexes have been published, and taxpayers who elected the LIFO method are preparing amended returns based upon the official indexes.

Conclusion

These illustrations are by no means intended to leave the impression that economists are usurping the field of expert guidance to the tax administrator—that every time a difficult problem arises a distress call must be sent out for an economist. What is intended is to illustrate the expanding scope of problems entering into tax administration—problems that involve a perspective of a whole industry, problems that explore horizons beyond the view of the accountant and engineer, that yield to the disciplines of economics and statistics. Hardly a month passes but that some new problem, or some new aspect of an old problem, is presented to challenge the ingenuity of the economist in making practical applications of the theories, data, and techniques of the science, largely prepared for the college classroom or developed by an abstract theorist for his like-minded colleagues. Not the least interesting aspect of the work is the necessity of presenting the analyses and conclusions in a form that will be understood by and be convincing to laymen—the administrator and counsel for taxpayers—and that will, if necessary, be convincing to the lawyers and the judges, and come within the bounds of “due process of law.”

THE ECONOMIC CLASSIFICATION OF CITIES AND ITS FISCAL IMPLICATIONS

CARL H. CHATTERS *

CITIES have personality and character just as people do. A city's personality is revealed in part by its economic and social background and the quality of its public administration. The investor surveys the character of a city in much the same way as the banker looks at the income, property, and personal traits of a person who applies for a loan. Persons who deal with municipal finance regularly have learned to classify the cities in whose credit they have an interest just as bankers involuntarily classify those who seek credit from them. Both bankers and investors are aware that character in an individual and administration in a city may be more important than the more tangible evidence of economic ability.

Several recent studies have been made in an attempt to place cities in definable economic or functional classes.¹ Occupation and employment have been used as criteria for this purpose because

such data were available for the selected groups of cities. Harris classifies the cities of 25,000 population and over into manufacturing cities, retail centers, diversified cities, wholesale centers, transportation centers, mining towns, university towns, and resort and retirement towns. Mrs. Ohlson extends her classification to cities over 10,000 population and adds governmental centers and dormitory suburbs.

The 1,041 cities over 10,000 population are first classified into independent (543), central (165), and suburban (333). The central cities are the central cities in a metropolitan area; the suburbs are tributary to the central cities; while the independent city is not part of any metropolitan area. These same cities are then divided into twelve economic classes, each containing the number of cities indicated: mining (29), transportation (12), manufacturing (267), industrial (89), diversified manufacturing (98), diversified retail (163), retail (135), wholesale (13), resort (20), education (31), government (18), and dormitory suburbs (166).²

Each economic or functional class of cities may have special conditions that affect its debts or revenues. Special policies with respect to municipal debt may be advisable in some classes of cities. And some types of revenues

*The author is professor of municipal administration and finance at Northwestern University. He was Executive Director of the Municipal Finance Officers Association from 1932 to 1946.

¹ Chauncy D. Harris, "A Functional Classification of Cities in the United States," *Geographical Review*, XXXIII (1943), 86-99; Grace Kneedler Ohlson, "Economic Classification of Cities," *Municipal Year Book*, 1945, 1946, 1947; Chauncy D. Harris, "Suburbs," *American Journal of Sociology*, XLIX (1943), 1-13; Homer Hoyt, "Economic Background of Cities," *Journal of Land and Public Utility Economics*, XVII (1941), 188-195; M. Auroousseau, "The Distribution of Population: A Constructive Problem," *Geographical Review*, XI, No. 4 (1921), 563-592.

² Ohlson, *op. cit.*, *Municipal Year Book*, 1946, p. 40.

may seem more desirable than others to supplement the local real estate tax. Whether the municipal revenues are used to pay debt charges or operating expenses, they are dependent on the maintenance of real estate values which are the principal base of the local revenue system. Homer Hoyt has said: "The future income and consequently the value of all urban real estate in any given city depends in the first instance on the maintenance and growth of the fundamental sources of employment."³ Therefore the classification of cities based on employment data is particularly appropriate for considering the financial characteristics of groups of cities.

Fiscal Stability of Different Classes of Cities

The real estate tax collections on which cities depend so heavily for their income are most stable over a long period of time in the wholesale and retail centers and diversified cities. Collections are least stable in resort cities and single industry or undiversified manufacturing cities. The twenty cities⁴ with most stable tax collections from 1930 to 1946 included Atlanta and Augusta, Georgia, and Los Angeles, California, (all diversified); Dallas, Texas, Denver, Colorado, and San Francisco, California, (wholesale centers); and Fresno, California, (a retail center). It was not surprising to find that the list of twenty cities with most unstable collections over the sixteen year period included the resort cities of Ashville, North Carolina, and Atlantic City, New Jersey, and the undiversified industrial cities of Canton and Dayton,

Ohio; Detroit, Flint, Grand Rapids, and Pontiac, Michigan; and Chester, Erie, Johnstown, McKeesport, and Reading, Pennsylvania.

The credit standing and economic stability of the largest cities is usually taken for granted. This presumption in favor of the large city springs in part from the fact that most cities tend to become diversified as they grow larger. For instance, only five of the thirty-six cities over 250,000 population are classed as manufacturing or industrial cities. Of the other thirty-one, there are twelve diversified cities where manufacturing predominates, eighteen diversified cities with a retail background, and one where retailing predominates.⁵ For the cities under 250,000 population, size alone is no conclusive evidence of a diversified economic character. The five cities over 250,000 population that were not diversified include Detroit, Cleveland, Jersey City, Providence, and Rochester. Detroit had to refund its debt after defaulting. Cleveland had a temporary delay in paying the principal of its debt in 1934 and refunded \$30,000,000 debt maturing from 1936 to 1942. Jersey City did not escape all financial troubles. Providence maintained a stable record of tax collections.

Another generalization based on observation and experience concludes that the more stable cities, from the viewpoint of municipal finance, are the diversified cities, education centers, and government centers. Wholesale centers are more stable than retail centers. Dormitory towns generally follow the economic movements of the cities on which they are dependent. Least stable as classes are the one industry or undiversified manufacturing cities, mining towns, and resort centers.

³ Hoyt, *op. cit.*, p. 188.

⁴ Frederick L. Bird, *The Trend of Tax Delinquency, 1930-46* (Dun and Bradstreet, 1947).

⁵ Ohlson, *op. cit.*, 1946, p. 40.

Finances of Each Class of City

The various classes of cities are examined below to see what general conditions may affect municipal finance, to determine if any special debt policies are necessary, and to reveal the special revenues that might be used in each class to supplement the local property tax.⁶

Resort and Retirement Towns.—These places would be expected to have a fluctuating and seasonal population and the possibility of real estate booms such as those which took place in Atlantic City, Asheville, and Miami. Such conditions would naturally lead to an unstable debt situation and to heavy demands for many kinds of public facilities in addition to those normally maintained by a city. This is exemplified by the "Boardwalk" in Atlantic City and the extensive water front in Miami.

The situation with respect to resort towns has been characterized as follows: "Resort towns where a large percentage of the population is transient are uncertain risks, since they are in danger of a loss of business both from cyclical causes and from changes in fashion. . . . While a resort is popular it looks as if it will always be so, but there is the risk that a newer resort will attract the fickle public. In the period of decline, the tax income is likely to be inadequate to support the elaborate and expensive improvements made during the boom. Resorts are particularly hazardous if numerous other locations can be developed with

about the same attractions."⁷

There are, however, special revenues which might appropriately be levied in resort cities. These levies would bear far more heavily on the transient population than on the resident population. The special revenues appropriate to such communities are the amusement tax, alcoholic beverage tax, cigarette tax, selected sales taxes on luxuries and hotel meals, and a special tax on hotel rooms.

Atlantic City has experimented with all of the special revenues recommended above and now has them in force. They were passed once, but the State enabling act was declared unconstitutional. A remedial act of a broader nature was passed by the State legislature, and subsequent to it, Atlantic City readopted the special levies.

Transportation Centers.—The transportation centers are cities where a large portion of the workers are engaged in transportation and communication. Included in this group are: Mobile, Alabama; Jacksonville, Florida; Danville and Galesburg, Illinois; Elkhart, Indiana; Council Bluffs, Iowa; Portland, Maine; Port Huron, Michigan; Altoona, Pennsylvania; and Green Bay, Wisconsin.

In the transportation centers there will likely be found a relatively large floating population. Employment will be subject to seasonal and cyclical layoffs. Technological changes or changes in transportation routes may seriously cripple nearly any one of the transportation centers.⁸ As railroad equipment

⁷ *Municipals*, Committee on Municipal Obligations, National Association of Supervisors of State Banks, Federal Deposit Insurance Corporation (Washington, D. C., 1941), p. 47.

⁸ Leverett S. Lyon, "Economic Problems of American Cities," *American Economic Review*, XXXII (1942), 309-322.

⁶ A. M. Hillhouse and Muriel Magelssen, *Where Cities Get Their Money* (Municipal Finance Officers Association, 1946) and *Supplement* (1947).

has improved and changed, the railroads have fewer division points and fewer major maintenance shops. The airlines may transfer large numbers of employees readily from place to place as they have done in the past. Even water transportation centers may change in importance if their piers burn, as they did in Hoboken, or if some steamship line changes its terminals.

Because of the somewhat uncertain nature of the community's income, the debts of transportation centers ought to be kept below the average for cities in their population group, and the debts ought to be for relatively short terms. The only special revenues that might be recommended for such cities are amusement taxes and business license taxes based on the volume of business.

*Industrial and Manufacturing Cities.*⁹—There is a difference in the degree to which the cities in this class depend on manufacturing for employment. Included in the industrial cities are many one industry cities. The latter, typified by the automobile manufacturing cities of Michigan, are not only devoted primarily to manufacturing but also are further limited by the existence of a single industry. But there are industrial cities which have diverse industries, and those in which the industry and manufacturing are supplemented by a large volume of retail or wholesale trade. In the one industry cities, problems of revenue and debt are most acute, and creditors look at such towns with more uncertainty than they do at the diversified industrial cities.

But in all of the manufacturing or industrial cities, employment is affected by the economic cycle more radically

than it is in the other types of cities. Many of the industrial cities have mushroomed in population, and therefore were required to go in debt rapidly in order to provide public facilities. In this type of city, the payrolls and employment increase sharply with improvement in the business cycle, but, at the opposite pole, decline even more rapidly than do other types of communities. For the industrial cities as a whole, it would seem well to have debts with a relatively short term; to watch for high per capita debts which may have resulted from very rapid growth. It would be a wise policy to pay for improvements out of current revenues during prosperous times, and to reduce debt during prosperous times. Certain special revenues may be used by this type of community, and most of the revenues, even of the ordinary nature, should be increased during prosperous times.

The industrial cities could use a payroll tax similar to that in Philadelphia and Toledo. There might also be a tax on factories based on the number of employees. The industrial cities, because of the threat of unemployment and because of the fluctuating character of the population, are more likely to need state equalizing grants than are the other cities. Tax delinquency of a serious nature is more likely to occur in the industrial cities than in most other classes. All of this sums up to the fact that the heavily industrialized cities need to impose special taxes to supplement the property tax and to keep debts low. They may well increase taxation during prosperous days, and they must guard their finances because of the danger of tax delinquency and the probability of high per capita debt.

⁹ *Municipals*, *op. cit.*, pp. 42-49.

University or Educational Towns.—This category includes places where a university dominates the city. In this group are Boulder, Colorado; Gainesville, Florida; Urbana and Champaign, Illinois; Iowa City and Ames, Iowa; Ann Arbor, Michigan; Columbia, Missouri; and Ithaca, New York.

University towns ordinarily have a stable population and consistent community income. The politics and administration of the city are usually favorable to good financial management. However, the abundance of tax-exempt property results in high rents and high tax rates. As a rule, the stabilizing influence of the educational institutions far more than overcomes the danger from the abundance of tax-exempt property. Usually the municipal debt is no serious problem in this type of city.

Some special revenues that might be used to advantage are license taxes based on the volume of business, parking meters, amusement taxes, and relatively high municipal utility charges. The latter would help to recover some revenue from the properties that are exempt from the general property tax.

Retail Centers.—Although the retail centers might be expected to fluctuate economically as much as any other class of city, they appear to have been more stable than the industrial, mining, or resort cities. In fact they appear to be as stable as any class of community. Retail sales may decrease in times of adversity, but employment in the retail centers has not been affected as adversely as it has in other places. Public and private income have been relatively stable, and the cities themselves which have developed into retail centers have had a stable rate of growth. Furthermore, most of the important retail cen-

ters are among the medium sized cities—that is, those between 25,000 and 100,000 population. Eight state capitals are in this group, which includes the following cities: Fresno and Stockton, California; Orlando and Lakeland, Florida; Lincoln, Illinois; Wichita, Kansas; St. Cloud, Minnesota; Lincoln, Nebraska; Raleigh, North Carolina; Aberdeen, South Dakota; Austin, Amarillo, San Angelo, Tyler, and Big Spring, Texas; Charlottesville, Virginia; and Madison, Wisconsin.

There appear to be no special characteristics regarding their municipal debts. The only special revenues that may be recommended for them are amusement taxes and gross receipts license taxes for retailers. This type of city appears to typify the normal diversified American city with no special problems to distinguish it.

Wholesale Centers.—The wholesale centers are more stable than the retail centers. This naturally follows since they draw trade from a wider area and therefore are less susceptible to the changes in a single city. In other words, they spread the risk over the whole area for which they serve as a wholesale center. Therefore, employment in wholesale centers is fairly steady, and the financial situation of the city is stable.

Cities which typify wholesale centers are: San Francisco, California; Denver, Colorado; Sioux City, Iowa; Omaha, Nebraska; Fargo, North Dakota; Oklahoma City, Oklahoma; Memphis, Tennessee; Dallas, San Antonio, and Waco, Texas; Salt Lake City, Utah; and Seattle and Yakima, Washington. This class of city as such has no special problem of debt. Only one special type of revenue is recommended, namely, a gross receipts tax on wholesalers, based

on the volume of business, similar to the tax employed in the city of Richmond, Virginia.

Diversified Cities.—The diversified cities have a satisfactory combination of manufacturing, retailing, and wholesaling, as well as a diversification of industry. Of the cities which are classified as diversified, fourteen are state capitals. The latter characteristic adds further to the diversified nature of the city. It naturally follows that the diversified cities have a relatively high degree of stability with respect to private and public income and that from their nature they present no special problems of debt. There may be other factors of course in the cities' make-up which may provide debt problems, but these will not arise primarily because of their economic background. In this group are some of the cities with the highest credit rating in the United States, such as Indianapolis, Baltimore, Houston, and Richmond.

However, just to prove that there is an exception to every rule, the city of Boston is found among the diversified cities. Its financial troubles arise from the nature of the metropolitan area in which it is located and from the kind of municipal administration it has enjoyed over a period of years.

The diversified cities have tended to diversify their revenues also. Birmingham, Alabama, for instance, relies heavily on business license taxes. Baltimore, Maryland, has invoked several new revenue sources within the past year. Richmond, Virginia, was a pioneer in the levying of business license taxes based on the volume of business. These cities have a diversified nature, and from their very character are able to use almost any of the sources of local

revenue which cities generally find satisfactory. Probably for this group one of the most desirable objectives would be the establishment of a level rate of taxation on real estate.

Mining, Lumbering, and Oil Towns.—Many cities are dependent on extractive industries, such as coal mining and oil, or the production of wasting assets such as lumber and ore. In this group would be included the cities of Ironwood, Michigan; Hibbing and Virginia, Minnesota; Butte, Montana; Hazleton, Pennsylvania; and Bluefield, West Virginia. Many towns in this class are unusually prosperous. Only a special analysis of the area assets can reveal whether prosperity is permanent or likely to be short-lived.

These towns would be expected to reveal seasonal unemployment and employment of the "boom or bust" variety. They are usually one-industry towns with all the characteristics of such places. There is the danger of the depletion of the natural resources on which they depend. Special provisions for municipal debts and municipal revenues therefore seem highly desirable. In the mining, lumbering, and oil towns, the debts ought to be low and have a short term. Much of the debt should be callable and all of it should be measured in terms of the time when the raw materials on which the town depends will be depleted. Such towns may be expected to have relatively high tax rates which they can stand during prosperous times. They may well employ special local taxes based on the quantity of production of raw materials. They should try to pay for improvements out of current revenues or short loans and should derive a substantial amount of their revenue from taxes based on production. They

may find that amusement licenses and liquor taxes will be productive.

General Factors

It will be observed that no special debt problems or revenue measures are suggested for some types of cities while many suggestions are made for others. The retail centers, wholesale centers, and diversified cities present few special problems, and therefore few unusual recommendations are called for. On the other hand the transportation centers, resort and retirement towns, industrial cities, and mining, lumbering, and oil towns each have special characteristics which demand special treatment for debts and revenues. In each city, the nature of the private income needs to be examined to help determine the proper basis for local revenues.

It should not be inferred that the characteristics described above are the only ones which affect the debts and revenues of cities. There are of course many other factors. Population, population trends, and composition of the population are important. The nature of the revenue and the debt will be determined in part by whether the city is the central city in a metropolitan area surrounded by suburbs which draw on its resources.

Other economic and social factors to be examined are home ownership, local and other transportation, trend of employment and payrolls, retail sales per capita and in total, and the adequacy of public facilities to care for individuals and industries.

The rate at which the city has been growing in the immediate past will also be a material factor, and so will the stage which the city has reached in its development. Is it a growing city, a

mature city, or a decadent city? Cities which are still growing can naturally incur heavier debts and levy heavier taxes than the cities which have already passed their peak in population.

The character and source of community income needs to be examined in determining either the credit standing or the revenue sources of a city. Does the private income have as its base industry, trade, or accumulated intangible wealth? Is it a "payroll town" where only the payroll contributes to community income, and profits go to non-resident owners and stockholders? Will the growth of the city make it more or less resistant to changes in the economic cycle? Does the state in which the city is located contribute to municipal income by grants-in-aid or shared taxes and, if so, to what extent?

Even though most of the other factors may be favorable or unfavorable, the type of municipal administration may be the deciding factor as between the ability to pay debts and raise sufficient revenues and the possibility of either defaulting or skimping along on insufficient revenue. Good financial administration will permit a city to carry heavier debts than a city of similar wealth with poor administration or with no great desire to meet its obligations. Thus it must be understood that the economic characteristics of cities and the classes into which they fall are symptomatic and important in considering their finances, but their revenues and debts are affected by other factors. Finally, strong financial administration, which aims at collecting revenue promptly and at balancing the budget consistently over a long period of years, can offset many of the factors which superficially appear as unfavorable qualities in any class of city.

COORDINATION OF FEDERAL BUDGETARY AND APPROPRIATIONS PROCEDURES UNDER THE LEGISLATIVE REORGANIZATION ACT OF 1946

AVERY LEISELSON *

IT IS well known that in passing the Budget and Accounting Act of 1921 Congress provided executive responsibility for annual review of department and agency estimates, and for formulation of the Federal Government's fiscal program in advance of the beginning of the fiscal year. It is not so widely realized that in the course of the act's legislative history, Congress considered and deliberately rejected a proposal for legislative authorization of the budget along the lines of the council-manager plan or the British Cabinet model.¹ Congress altered its own procedure only to the extent of consolidating in a single committee on appropriations in each house all authority to review requests for funds and to recommend appropriations. This in no way provided that the President's budgetary "recommendations" would be considered in the form submitted or in terms of the policy

issues that seemed relevant to him. its own appropriations procedure Congress has never acted upon the budget as transmitted.² At no point in the procedure does Congress bind itself to consider the relationship between the total estimated appropriations and estimated revenues, or the division of estimates between the several purposes or categories of expenditure, whether broadly or narrowly defined.³

Under the Budget and Accounting Act, consideration of the President's budget is divided among ten subcommittees of the full House Committee on Appropriations. These subcommittees analyze the estimates, conduct hearings at which representatives of the agencies rather than of the President testify, and in executive (secret) sessions make their decisions and draft the appropriation bills embodying the amounts justified in the subcommittee's judgment by the subordinate agencies, to which for the most part funds are appropriated.

* The author is assistant professor of political science at the University of Chicago. He is indebted to George B. Galloway, Senior Specialist in Legislative Organization, Legislative Reference Service, Library of Congress, for a copy of his testimony before the Committee on Expenditures in the Executive Department, U.S. Senate, February 17, 1948, on "The Operation of the Legislative Reorganization Act;" and to Miss Louise Kachel, for her study of the legislative proceedings in 1947 and 1948 under sections 138-139 of the Legislative Reorganization Act.

¹ H. D. Smith, "The Bureau of the Budget," *Public Administration Review*, I (1941), 106 ff.; F. Morstein Marx, "The Bureau of the Budget: Evolution and Present Role," *American Political Science Review*, XXXIX (1945), 655-59.

² Interestingly enough, it is on the specific supplemental (deficiency) requests during the fiscal year, over and above the amounts contained in the annual budget, that Congress follows most closely the form and amounts of Presidential recommendations.

³ W. F. Willoughby, *The Problem of a National Budget* (New York, 1918). British practice is described in W. I. Jennings, *Parliament* (London, 1940), pp. 250-52, 290-318.

⁴ A. E. Buck, *The Budget in Governments of Today* (New York, 1934), chap. 7; A. W. Macmahon, "Congressional Oversight of Administration: The Power of the Purse," *Political Science Quarterly*, LVIII (1943), 161, 380.

The full House Appropriations Committee rarely makes changes in the bills and reports of its subcommittees, and the Committee of the Whole House acts under rigidly limited debate without benefit of the information or reports of hearings available to the subcommittees. The Senate Committee on Appropriations acts primarily as a channel for agency appeal from the determinations of the House subcommittees, with the possibility of arranging some compromises in conference between the two houses. Thus Congress acts upon the budget primarily with respect to its parts, and down to 1946 the principle of the executive budget as a device for enabling Congress to discuss and debate the budget as a whole had not been implemented as a matter of legislative policy or procedure.⁵

The Congressional disinclination to accept as authoritative the formulations of policy from the President or his cabinet advisers goes back at least as far as Alexander Hamilton,⁶ and it is unnecessary here to dwell upon the constitutional issue of Congressional versus Presidential control over administration. The history of the Federal budget since 1921 reveals clearly that Congress views the budget less as a systematic method for planning and debating the policy issues involved in arriving at an integrated fiscal program for the Government as a whole, than as a means of maintaining its own detailed control over the expenditures of particular administrative agencies. In the reorganization acts of 1939 and 1945, Congress

adopted the theory of executive responsibility for the management of the executive establishment to the unprecedented extent of providing a special rule of business for considering executive reorganization plans.⁷ Since 1939, however, there has been a growing tendency to criticize the President and his Budget Bureau for failing to produce more impressive results in the direction of reducing agency personnel and expenditures. This criticism illustrates again and again the Congressional reluctance to accept the concept of the budget both as its own tool of fiscal control and the President's tool of executive management.⁸ Recent years have witnessed discussion of proposals for enlarging Congressional committee staffs, suggestions for improving methods of communication and contact between Congress and the Executive, a heightened tempo of investigating committee activity, and finally, in 1945 the LaFollette - Monroney resolution setting up the Joint Committee on the Organization of Congress, whose work culminated in the Legislative Reorganization Act of 1946.⁹ Healthy and vigorous

⁷ J. D. Millett and L. Rogers, "The Legislative Veto and the Reorganization Act of 1939," *Public Administration Review*, I (1941), 176; L. Brownlow, "Reconversion of Federal Administration from War to Peace," *Public Administration Review*, IV (1944), 309.

⁸ Morstein Marx, *op. cit.*, pp. 894-97; *Hearings*, House Committee on Civil Service, Investigating Civilian Employment, 78th Cong., 1st Sess., pp. 300 ff; Senate Committee on Appropriations, *Hearings on Independent Office Appropriation Bill*, 1946, pp. 302-309; H. D. Smith, "The Budget as an Instrument of Legislative Control and Executive Management," *Public Administration Review*, IV (1944), 181.

⁹ Public Law 601, 79th Cong., 2nd Sess. (August 2, 1946); *Hearings Before the Joint Committee on Organization of Congress*, 79th Cong., 1st Sess.; Senate Report 1011, 79th Cong.; G. B. Galloway, *Congress at the Crossroads* (New York, 1946), chap. 8 and pp. 340-346.

⁵ As a matter of fact, the President's budget has actually had the effect of an over-all limitation on the amounts appropriated by Congress.

⁶ W. E. Binkley, *President and Congress* (New York, 1947), chaps. 2-3; Lucius Wilmerding, Jr., *The Spending Power* (New Haven, 1943), Part I.

as most of this discussion was, the principal results embodied in the Legislative Reorganization Act were a reduction in the number of Congressional committees and an increase in committee staffs, without substantial contribution to the top-level problems of legislative-executive relations.

The "Legislative Budget"

Section 138 of the Legislative Reorganization Act, which establishes, in the words of the statute, a "legislative budget," may seem to require exception to the statement that the law brought about no significant modification of Presidential - Congressional relations. This section developed out of an idea tossed into the committee hopper during hearings on the bill by representatives of the Connecticut Public Expenditures Council and the United States Chamber of Commerce.¹⁰ It requires the two revenue and appropriation committees of each house, or authorized subcommittees thereof, to meet and report to their respective houses not later than February 15 in each regular session a budget report and concurrent resolution based thereon, which would contain an authoritative determination of anticipated appropriation and revenue totals for the ensuing fiscal year. Section 138 further provides:

If the estimated receipts exceed the estimated expenditures such report shall contain a recommendation for a reduction in the public debt. . . . The report shall be accompanied by a concurrent resolution adopting such budget, and fixing the maximum amount to be appropriated for expenditure in such year. If the estimated

expenditures exceed the estimated receipts the concurrent resolution shall include section substantially as follows: "That it is the sense of the Congress that the public debt shall be increased in an amount equal to the amount by which the estimated expenditures for the ensuing fiscal year exceed the estimated receipts, such amount being \$"

The evident purpose of section 138 is, by the device of a joint committee adopting annual budget totals in advance, to fill the gap created by the absence of any Congressional procedure for arriving at a single, integrated fiscal program. The new device is based upon three ideas: (1) The Joint Committee should arrive at the proper overall relationships between appropriations and revenues on the basis of a month's deliberations before the appropriations subcommittees have completed their hearings and review of the President's estimates. (2) The Joint Committee's decisions can be made controlling upon the separate bills reported by the respective appropriations committees to the two houses. (3) A statutory requirement of an annual debate upon the issue of reducing or raising the public debt will provide the means, hitherto lacking, to compel Congress to make its fiscal decisions in a systematic, responsible, and consistent manner. A brief review of the course of events since the enactment of section 138 throws considerable light upon the validity of these assumptions.

Experience Under Section 138 of the Legislative Reorganization Act

The Legislative Reorganization Act became law August 2, 1946. On January 10, 1947, President Truman transmitted the first budget under section 138. Ten days later the 102 members

¹⁰ *Hearings Before the Joint Committee on Organization of Congress*, pp. 776-79, 890-904.

of the Joint Congressional Committee on the Legislative Budget had their first meeting. Three decisions were made. A twenty-member subcommittee (three Republicans and two Democrats from each of the four constituent committees) was appointed to investigate and recommend the proposed estimates of total revenues and appropriations for the ensuing fiscal year; the sessions of this working subcommittee were to be closed to the public and press; special appearances before the subcommittee were proscribed even by members of the full Joint Committee.¹¹ The latter rulings not unnaturally provoked charges of "gag rule," with the result that conflicts within the subcommittee leaked out and found their way to the floors of both houses before the group had finished its report. The decisive vote in the subcommittee was fully reported in the press.¹²

The accompanying table reveals the tactics of the Republican majority in subcommittee and full Joint Committee sessions. In brief, these were to raise the President's revenue estimate and lower his expenditure estimate. No criticisms were aroused by the changes in revenue calculations, but the expenditure alterations caused an immediate uproar. The attack took two forms: (1) In what areas would the reductions be applied? (2) Would the enlarged surplus be used for debt reduction or tax reduction? Was the Committee going to gamble with the military security of the nation, or to interfere with the restoration of Western water and power development projects postponed by the war? These

questions could not have been answered even if the subcommittee had entertained any ideas of making such decisions, for it did not possess the information upon which answers would have to be based. So, in the subcommittee on February 11, and the full Committee on February 14, the party majority was "applied" and a budget report and resolution carried that simply called for an over-all \$6.0 billion reduction in the President's expenditure estimate. This reduction, coupled with the increase in the revenue estimate, "would make \$3.5 billion available for a 20 per cent personal income tax reduction and an equal amount for payment on the national debt." In the face of bitter minority criticism, the House passed the resolution easily on February 19. In the Senate, a cleavage in the Republican ranks caused debate in the Senate to spread out until March 3, when an amendment to the resolution was accepted that reduced the President's expenditure estimate by only \$4.5 billion. The resolution went to conference, where it stayed. Whether deadlocked on the amount of the reduction, or on the question of whether the reduction should be applied to taxes or to the debt, no legislative budget was adopted for the fiscal year 1948.

The following year matters went much more smoothly. The Joint Budget Committee brought in its report, with a dissenting minority, on February 9, 1948. Debates in both houses were on the whole desultory, lasting less than a day in each case. The budget resolution passed without amendment, or even a roll call in the Senate. A marked atmosphere of cynicism and futility characterized the

¹¹ *New York Times*, January 21, 1947, p. 13.

¹² *New York Times*, February 12, and 15, 1947, p. 1; also, *Congressional Record*, 80th Cong., 1st Sess., Vol. 93, pp. 894-95, 920-24, 960-63.

proceedings.¹³ Republican leaders admitted that the resolution implied no commitment to reduce any specific appropriation bill; that the budget totals were only "a target to shoot at;" that the Joint Committee had no real idea of the proper relationship among expenditures, revenues, appropriations,

COMPARISON OF PRESIDENTIAL AND JOINT CONGRESSIONAL COMMITTEE BUDGETARY RECOMMENDATIONS, 1948-1949
(Billions)

Budgetary Totals, by Fiscal Years	Presi- dent's Budget	Joint Committee Report
1948		
Estimated Receipts	\$37.7	\$39.1
Estimated Expenditures	37.5	31.5
Excess of Receipts .....	.2	7.6
Limit (Expenditure) on New Appropriations .	31.3	27.0
1949		
Estimated Receipts	\$44.5	\$47.3
Estimated Expenditures	39.7	37.2
Excess of Receipts	4.8	10.1
Limit (Expenditure) on New Appropriations .	32.9	30.0

and debt; finally, that the Reorganization Act should be amended to allow the Joint Committee to report at a much later date. The Democratic authors of the Joint Committee's minority report differed from the majority primarily in being more sharply critical of the whole procedure, pointing out: (1) the time limitation made the Committee's recommendations arbitrary and ungrounded in fact; (2) the majority's recommendations made no indication of the items from which reduction were to be taken; (3) the whole report, being based upon undetermined and undeterminable factors, constituted an "indefensible subterfuge." The minority report then implicitly announced its agreement with the majority in proposing to continue, as in the past, "to

examine the appropriation requests in accordance with long-established procedure."¹⁴ Thus there is no prospect that the appropriations committees in 1948 will pay any more attention to the recommendations of the Joint Committee than they did in 1947 without a legislative budget resolution. Clearly, the process of nullification seems to be setting in.

Validity of Assumptions Underlying Section 138

With the benefit of this experience, we may now analyze further the assumptions underlying the legislative budget procedure embodied in section 138 of the Legislative Reorganization Act. The first of these assumptions was that the Joint Committee can determine the proper over-all relationships between appropriations and revenues after one month's deliberation and recommend a general policy by February 15 of each year. In view of the experiences of 1947 and 1948, the question may properly be raised whether this is a feasible objective. What the Committee can be expected to do depends partly on its organization and procedures and partly on the scope and character of the determinations it undertakes. The work of the Joint Committee seems to have been handicapped by the lack of a clear general agreement as to the nature of its function.

At least in retrospect, it seems clear that the real function of the Committee is an estimates function, that is, to make

¹³ *Congressional Record* (daily edition), 80th Cong., 2nd Sess., pp. 1454-62 (February 18, 1948); pp. 1940-51 (February 27, 1948).

¹⁴ 80th Cong., 2nd Sess., House Report 1361 on H. Con. Res. 147 (February 9, 1948). In the April, 1948, issue of the *American Political Science Review*, Clarence Cannon, ranking minority member of the House Committee on Appropriations and former chairman, characterizes the legislative budget provisions as "virtually defunct . . . a dead letter." XLII (April, 1948), p. 316.

the coordinated determinations of the estimates of appropriations within the over-all political decisions limiting the size of the Government's fiscal program. If this is true, the Committee has probably been handicapped by the fact that its membership includes representatives of the two revenue committees. From the evidence, it seems clear that the revenue members' interest in coordinating budgetary with appropriations procedure, or even in arriving at the proper allocation of appropriation amounts, is slight compared with their interest in the implications of budgetary decisions for tax policy. The desires of revenue committee members ought not to distort the determination of the estimates. In any case, tax policy is not a matter to be adjusted annually on the basis of appropriation estimates for the year. It only adds confusion to introduce the revenue viewpoint prior to the time the estimating of expenditure requirements has been authoritatively completed. It is true that a higher policy decision is required as to the over-all level of expenditures, but that is properly a matter for party policy or joint executive-legislative determination. From this standpoint, it seems desirable to make the Joint Committee clearly an estimates or budget committee, representative only of the appropriations committees of the two houses.¹⁵ It could then have a joint staff similar to that of the Joint Committee on Internal Revenue, which would facilitate joint hearings on appropriations, and expedite the determination of estimates within the over-all budgetary decisions. Possible procedures for the Committee are discussed in the concluding section of this paper.

¹⁵ D. T. Selko, *The Federal Financial System* (Washington, 1940), pp. 182-185.

The validity of the assumption that the over-all determinations of the Joint Committee would have authoritative effect is contingent upon finding some way of making the decisions of the Joint Committee procedurally controlling over the present autonomous powers of the committees on appropriations, particularly of the House. Under section 138 to date, nothing has been done to meet this condition. Technically, it could be done in either of two ways: (1) The Joint Committee could be given authority to fix ceiling amounts to the various bills or categories of appropriations, and to make binding reconciliations of the amounts, if not the form, of the appropriation bills recommended by the House and Senate subcommittees, with its February determinations, before such bills are introduced into either house. (2) The appropriations subcommittees could be required to submit their draft appropriation bills to the Joint Committee for review by the staff and membership of the entire Committee, to be considered in connection with the adoption of the estimates of appropriation as a whole. Both methods imply a reduction or consolidation of the number of appropriation bills, perhaps to two, one for the civil and one for the military estimates, as suggested by Marc Shields, the able former Clerk of the House Appropriations Committee.

Either of these measures, to be successful, should be based upon a system of appropriation schedules uniformly used both in the President's budget and by the Congressional committees. Otherwise there would be no way of insuring that the appropriations subcommittees would consider either the President's estimates or the Joint Committee's decisions in terms of the same

categories of analysis. Section 139 (b) of the present law evidently envisaged this problem, since it directs the committees on appropriations of the two houses, acting jointly, "to develop a standard appropriation classification schedule which will clearly define in concise and uniform accounts the sub-totals of appropriations asked for by the agencies in the executive branch of the Government." To date this also remains an unenforced provision of the law. It is fervently to be hoped that some way can be found to get the staff of the Budget Bureau and the Congressional appropriations committees to work on this problem. The failure to act to date no doubt reflects in part the existing variation in methods of presenting and justifying appropriation requests among the executive departments and agencies. But the real problem is not one of technique, since there is no necessary reason why all agencies must follow the same method below the level of the subtotals for the functional categories of appropriation. The effective obstacle is the preferences of the subcommittee members for the established wilderness of hundreds of appropriation "items" around which the Congressmen have developed their own sense of familiarity with agency operations. There is a deep suspicion on their part that the agencies would be enabled to put something over on them if the customary appropriations structure were changed to conform to an over-all classification system.

We may also question the assumption that Congressional responsibility for acting upon the budget as a whole, in advance, can best be developed by imposing the fixed requirement of an annual debate on the issue of reducing

or increasing the national debt. In the first place, we now see how simple it is to avoid the issue by failure to agree on a concurrent resolution. Secondly, the record is clear that the Joint Committee, as presently constituted, finds it difficult to act as a responsible unit on this question. The Committee is divided party-wise, by considerations of House-Senate prestige, and by the conflicting interests in tax and expenditure policy. The achievement of unity on a majority-minority basis through the party mechanism has been absent during the 80th Congress. However, even if the same party controlled both the White House and Congress, it is still uncertain that the majority members of the Joint Committee would place party cohesion above the constitutional "prerogatives" of Congress with respect to the spending power. The tenuousness of party responsibility on vital policy issues in the American system seems to exhibit itself in the form of avoiding, if at all possible, fixed points of conflict, such as the debt issue would present. If it is correct to regard the management of Congress as a matter of procedure, prestige, and custom, it would appear that in matters of Congressional reform it would be best to use party majorities for the innovation of changes in the rules of procedure that govern the distribution of power, rather than in "staging" policy battles.

Possible Courses of Development

This brief examination of sections 138-139 of the Legislative Reorganization Act of 1946 and of experience under them suggests three alternative lines of development.

1. Congress may allow the process of practical nullification of these provisions to continue, at least until there

has been some experience under an administration supported by a majority party in both houses. *Nullification would not be unacceptable* to those confirmed believers in the executive budget principle who entertain no hope of any good whatsoever emerging from the legislative budget idea. Government spending advocates, whether because of principle or because of preference for statutory myth coupled with the reality of subcommittee control over appropriations, may for different motives prefer the status quo. But those who desire substantial improvement in the quality of legislative control over fiscal planning, as well as those who perceive the importance of bringing executive and legislature closer together in the interests of responsibility to the nation rather than in maintaining a political dogma, will scarcely rest content with the present situation. Notable among these is the business group associated with the Committee for Economic Development, whose 1947 report on *Taxes and the Budget* is infused with a progressive spirit of continued reform.¹⁶

2. The Joint Committee may reverse the precedents of 1947-48 by accepting the President's estimates as the basis for its February determinations, as contemplated by the present law. This appears to be the most unlikely alternative, for the idea of the legislative budget accentuates the tendency to question the validity of the Presidential estimates rather than to use them as the springboard for legislative discussion and review of his policy decisions. In addition if the Joint Committee refuses to accept the budget figures sub-

mitted by the President, it faces the fact that by February 15 the appropriations subcommittees have scarcely begun their hearings on the agency estimates. It, however, is not impossible that the Joint Committee might adopt over-all budget totals in disregard of the President's recommendations. In this case, if the Joint Committee takes its function seriously, sooner or later it will have to resort to the arbitrary method of imposing ceilings or allocations in order to enforce its decisions upon the several appropriations subcommittees.

3. The Joint Budget Committee may decide to postpone its own decisions until the agency requests and Presidential estimates have been reviewed, and appropriation bills prepared, by the House appropriation subcommittees (or by joint House and Senate subcommittees aided by a joint staff). These bills and supporting schedules of estimates might be required to be submitted to the Joint Committee not later than, say, April 1 or 15. There might then be a period for intensive review and discussion of the subcommittee recommendations by the Joint Staff and membership of the full Joint Committee (of estimates and appropriations only), culminating in the joint submission by May 1 or 15 to both houses of one omnibus bill or two (a civil and a military) appropriation bills and the budget estimates including the over-all determination of total appropriations for the coming year, and the division of estimates for the major categories of expenditure, together with any recommendations for tax or debt action in the discretion of the Joint Committee. The form of action on the estimates in either house could be left to the party caucus or other appropriate

¹⁶ A Statement on National Policy by the Research and Policy Committee of the Committee for Economic Development (Chicago, 1947), pp. 16-19; also, see the *Economic Report of the President*, January, 1948, p. 31.

machinery to decide through changes in the rules of the two houses. The British practice shows very clearly that successive and final votes may be taken either on very broad or very narrow classifications of the estimates, as the houses may choose.

Alternatives 2 and 3 are not mutually exclusive. Both should be based upon a common system of estimates classification that ought to be developed in any event. The reason for distinguishing the two courses of action lies solely in the problem raised by the refusal of the Joint Committee to accept the President's budgetary figures. Neither

course is impractical or utopian, except as it challenges the symbolism and custom supporting the power of the House subcommittees on appropriations to act both as judge of the facts (the detail of estimates) and of budgetary policy. The sheer volume of time and effort involved in estimates review prevents the policy questions from securing proper consideration. Until the Joint Committee lifts the coordinating function out of the hands of the subcommittees, the prospects of balanced legislative control of budgetary policy appear remote.

TAXATION REFORM IN OCCUPIED JAPAN *

HENRY SHAVELL †

ONE of the less publicized yet highly significant activities of the Allied Occupation in Japan has been its supervision of Japanese tax reform and administration. Allied interest in Japanese taxation stemmed from two Occupation objectives, one social, the other economic.

An explicit social aim of the Allied authorities in Japan was to lay down policies "with the object of insuring a wide distribution of income and ownership of the means of production and trade."¹ In effecting such policies, the Japanese tax mechanism was extensively employed. Taxes were designed to favor a social climate more conducive to the growth of democratic institutions. A capital levy was imposed primarily to level off excessive concentrations of economic power, and to virtually wipe out the equities of a designated group within the economy, namely the *Zaibatsu*. Personal direct taxes were radically overhauled to achieve more progressive incidence and to check further tendencies toward marked wealth maldistribution.

* Much of the material presented here has appeared in an earlier article, "Postwar Taxation in Japan," *Journal of Political Economy*, LVI (April 1948), 124-37. Permission has been granted by the *Journal of Political Economy* for the reuse of selected sections of the earlier article.

† The author is Taxation Advisor to the Finance Division, Economic and Scientific Section, General Headquarters, in Tokyo. In this capacity since March, 1946, he has supervised for the Allied Occupation Japan's postwar taxation reforms.

¹ "Basic Post-Surrender Policy in Japan," *Bulletin of the U.S. Department of State*, August 3, 1947, p. 219.

tion. "Luxury" and sumptuary indirect taxes were increased, while taxes bearing upon more essential cost-of-living goods were lessened. In short, nonfiscal objectives factored heavily in shaping Japan's postwar tax policy.

Another, and at the moment more important, objective of the Allied Occupation was to work towards earliest stabilization of the Japanese economy.² This objective assumed increasing significance during late 1946 and 1947, when serious inflationary pressures and marked economic dislocations threatened to retard many Occupation reforms and to prolong the cost of occupying Japan. It became increasingly apparent, with the near-completion of the Occupation's broad demilitarization and disarmament programs, that greater emphasis had to be placed upon securing economic stabilization within Japan. Japanese taxation came to be employed as a key counter-inflation weapon, under the guidance of Occupation authorities.

Under the direct supervision of Occupation authorities, the Japanese government initiated an ambitious and comprehensive fiscal experiment in the Fall of 1946. The experiment, while still incomplete, has thus far included such fiscal rarities as a 100 per cent war debt cancellation tax and a capital levy reaching up to

² "We hold to . . . [the] definite purpose of building in Japan a self-sufficient Democracy, strong enough and stable enough to support itself. . . ." (Address by Secretary of the Army Kenneth C. Royall, Commonwealth Club, San Francisco, January 6, 1948.)

90 per cent of total property holdings, a modernized pay-as-you-go personal income tax, the substitution of self-assessment for government assessment of taxes, an estate and gift tax, capital gains taxation, a modified form of corporate and personal income tax integration, and sweeping revisions in the national and local tax structure

Background for Tax Reforms

Under the impetus of expanding war requirements, the gap between Japanese government^{1a} expenditures and revenue grew wider and more significant in the later war years. With the "North China Incident" developing into the "China Affair," government

TABLE 1
JAPANESE NATIONAL GOVERNMENT EXPENDITURES AND REVENUES IN RELATION TO NATIONAL INCOME,
FISCAL YEARS 1934-35 TO 1946-47
(Amounts in Billions of Yen)

Fiscal Years Ending March 31	National Income ^a	Expenditures ^b		Revenues ^c	
		Amount	Per Cent of National Income	Amount	Per Cent of National Income
1935	14.3	2.2	15.4%	1.5	10.5%
1936	15.6	2.2	14.1	1.6	10.3
1937	17.2	2.4	14.0	1.8	10.4
1938	20.4	5.5	27.0	2.3	11.3
1939	24.2	8.1	33.5	3.0	12.4
1940	30.0	9.0	30.0	3.9	13.0
1941	34.0	11.0	32.3	5.7	16.8
1942	45.4	19.3	42.5	6.4	14.1
1943	56.9	29.7	52.2	9.5	16.7
1944	76.8	37.1	48.3	13.6	17.7
1945	115.0	77.7	67.5	17.3	15.0
1946	155.0	104.0	67.0	16.8	10.8
1947	400.0	119.1	29.8	54.9 ^d	13.7 ^d

Source: Ministry of Finance, Japanese Government.

^a Calendar years through 1944. Data for 1945-46 and 1946-47 represent revised fiscal year estimates by National Income Section of the Ministry of Finance.

^b General account expenditures for all years. Includes also special war account appropriations for fiscal years 1937-38 to 1945-46. Represents budget appropriations for all years through 1945-46. Settled account expenditures for 1946-47.

^c General account budget estimates for all years through 1945-46. Settled general account revenues for 1946-47.

^d Includes 11.5 billion yen of capital levy realized proceeds.

of the nation. The scope and rapidity of tax developments undertaken in Japan in the past year and one-half is perhaps without parallel in modern fiscal history. Because of the unique circumstances surrounding these developments, a study of Japan's taxes under the Occupation should prove of interest to taxation circles the world over.

spending in fiscal 1937-38 had increased in magnitude to approximately 27 per cent of the national income, while revenues comprised 11.3 per cent of the national income (see Table 1). Fol-

^{1a} The term "Japanese government" as used throughout this article refers solely to the national government as distinguished from the various local governments.

lowing the attack on Pearl Harbor, Japanese government expenditures rose to 52.2 per cent of the national income in the fiscal year ending March 31, 1943, and to 67.5 per cent in fiscal 1945, while revenues accounted for just 16.7 per cent and 15.0 per cent of the national income in the corresponding

by more than 3,000 per cent from average 1941 levels to the end of June, 1947. In the same six-year period, wages had risen by roughly 2,200 per cent, and retail prices by 2,100 per cent (see Table 2).

Inflationary dislocations were compounded by food and other commodity

TABLE 2
INDEXES OF CURRENCY ISSUE, PRICES, AND WAGES, JAPAN, 1941-48

Year and Month	Currency Issue ^a	Retail Prices ^b	Wholesale Prices ^c	Wage Rates ^d
1941 average	100	100	100	100
1942 average	126	104	108	108
1943 average	168	113	114	123
1944 average	281	128	127	153
1945 average	730	192	163	197
1946 average	1,213	1,037	767	785
1947:				
January	2,279	1,535	1,156	1,358
February	2,404	1,685	1,156	1,445
March	2,637	1,787	1,169	1,627
April	2,789	1,947	1,427	1,807
May	2,955	2,042	1,553	2,141
June	3,106	2,161	1,606	2,281
July	3,275	2,806	2,766	2,499
August	3,433	3,419	2,916	2,773
September	3,564	3,741	2,998	3,079
October	3,820	4,173	3,372	3,328
November	4,059	4,571	3,701	3,530
December	4,993	5,061	3,820	3,869
Average	3,278	2,911	2,303	2,480
1948:				
January	4,968	5,302	3,941	....
February	4,906	5,494	....	....
March	4,983	....	....	....

^a Bank of Japan note issue as of end of month.

^b *Oriental Economist* index based upon Chamber of Commerce and Industry survey for Tokyo.

^c *Oriental Economist* index based upon Bank of Japan Tokyo survey.

^d Based upon data of Cabinet Bureau of Statistics, Japanese Government.

periods. Even in the fiscal year ending March 31, 1946, early in which Japan was defeated, the Japanese government deficit alone amounted to over 56 per cent of the estimated national income.

Mounting government deficits such as these had unleashed a currency inflation of serious proportions. The Bank of Japan currency issue had multiplied

shortages, labor unrest, and the prevalence of a flourishing black market. From one-third to one-half of the 1946 estimated national income was believed to have been transacted on the black market. Consumer surveys indicated that over 70 per cent of urban family expenditures were made at black market prices several hundred times higher

TABLE 3

DISTRIBUTION OF JAPANESE TAX REVENUE ^a FOR SELECTED FISCAL YEARS, 1940-41 TO 1947-48

Tax	Amounts (Millions of Yen)				Percentage Distribution			
	1940-41	1945-46	1946-47	1947-48 ^b	1940-41	1945-46	1946-47	1947-48 ^b
<i>National government taxes:</i>								
Personal income tax ...	1,489	3,820	12,073	69,044	33.8	33.4	36.6	43.6
Excess profits tax ^c	737	1,961	1,275	158	16.7	17.1	3.8	0.1
Increased income tax ..	....	....	5,700	9,000	...	...	17.2	5.7
Corporation tax	182	1,162	1,269	6,300	4.1	10.2	3.8	4.0
Estate and gift tax ^d ...	57	177	369	361	1.3	1.5	1.1	0.2
Non-war sufferers special tax .....	....	....	....	6,541	...	...	...	4.1
Land and house taxes ^e	25	61	72	90	0.6	0.5	0.2	0.1
Business tax ^e	50	125	167	110	1.1	1.1	0.5	0.1
Liquor, beer, sake tax ..	285	1,131	2,331	23,870	6.5	9.9	7.1	15.0
Commodity tax	110	533	2,214	7,845	2.5	4.6	6.7	4.9
Admission tax	23	296	1,042	6,518	0.5	2.6	3.2	4.1
Textile excise	65	91	1,077	2,117	1.5	0.8	3.3	1.3
Horse-racing tax .....	....	1	2	463	...	...	...	0.3
Miscellaneous taxes ^f ..	842	1,127	2,150	2,973	19.1	9.9	6.5	1.9
Total national taxes ^g	<u>3,865</u>	<u>10,485</u>	<u>29,741</u>	<u>135,390</u>	<u>87.7</u>	<u>91.6</u>	<u>90.0</u>	<u>85.4</u>
<i>Local government taxes:</i>								
Citizens' poll tax	67	108	1,644	8,578	1.5	0.9	5.0	5.4
Surtaxes on national business tax ^h	136	383	709	10,453	3.1	3.3	2.1	6.6
Surtaxes on national land and house taxes ^h ..	211	254	465	1,551	4.8	2.2	1.4	1.0
Miscellaneous taxes ⁱ ..	127	214	474	2,624	2.9	1.9	1.4	1.6
Total local taxes	<u>541</u>	<u>959</u>	<u>3,292</u>	<u>23,206</u>	<u>12.3</u>	<u>8.4</u>	<u>10.0</u>	<u>14.6</u>
Total, national and local taxes	4,406	11,444	33,033	158,596	100.0	100.0	100.0	100.0

^a Tax receipts only. Figures for "total national taxes" in this table differ from national government revenues shown in Table 1, as the latter data include nontax as well as tax receipts. Principal revenue items included in Table 1 but not in Table 3 are: profits derived from the national government tobacco products monopoly (7,674 million yen in 1946-47), capital levy proceeds (11,543 million yen in 1946-47), and miscellaneous fees and penalties (5,909 million yen in 1946-47).

^b Budget estimates.

^c The excess profits tax was imposed at the personal, as well as the corporate, level. For corporations, the tax was imposed upon profits in excess of the average annual profit rate for the period 1934-36, or in excess of 10 per cent of average capital employed (stock par value, working capital, undistributed profits, and designated reserves). For individuals owning unincorporated businesses, the excess profits tax was also imposed upon current profits in excess of average 1934-36 profit rates. In the event that a base period profit rate was indeterminate or unusual, other base standards were substituted by the government. Capital gains realized from real estate transactions were added to the scope of the tax in 1943. The tax as such was abolished in April, 1946, accounting for its smaller revenue for that year. Its basic components were not dropped, however, but were integrated with the personal income and corporation taxes. An excess profits tax on corporations was continued without a break in continuity under the heading of the corporation tax for 1946 but at reduced rates. Capital gains on real properties were simultaneously made taxable as a component of the personal income tax. Excess profits taxation on unincorporated businesses was abolished.

^d Represents inheritance tax receipts for all years except 1947-48.

^e These taxes were transferred to local governments effective April 1, 1947.

^f Includes sugar excise, haircut and beauty parlor tax (abolished March 31, 1946), soft drink tax, transportation tax, tonnage tax, building construction tax (abolished March 31, 1946), amusement and recreation tax (transferred to local governments April, 1947), special tax on foreign currency securities (abolished March 31, 1946), special tax on dividend and interest payments (abolished March 31, 1945), mining lot tax, securities transfer tax, bourse tax, customs duties, special corporation tax, and stamp tax. [Footnotes continued on next page.]

than "official prices."

With the accelerated progress of inflation following the war's end, the productivity as well as the equity of the tax system declined markedly (see Tables 1 and 3). Black market and other illicit income, which had risen greatly in both absolute and relative terms since the Fall of 1945, had engendered widespread evasion of direct taxes. Laxity in tax enforcement, for which Japanese tax officials have hitherto been notorious, coupled with the breakdown of taxpayer and tax collector morale, was another factor contributing to falling tax productivity.

The personal income tax of 1945 and 1946 had meanwhile degenerated into a disproportionate levy on wage and salary income. While the latter was almost entirely taxed at source, other forms of income were taxed from seven months to two years following receipt.³ With the purchasing power of the yen falling rapidly, payment of income taxes in greatly depreciated currency cut deeply into the government's *real* revenue, as well as into the equity of the tax structure. While the personal income tax had absorbed almost 4.4 per cent of the national income in 1940-41, the corresponding ratio for 1945-46 approximated only 2.4 per cent.

³ Under the 1946 and earlier income tax laws, payment of tax not withheld at source was due on August 31 of the year following the taxable calendar year, and on January 31 of the second year following.

* Excludes capital levy and war indemnity tax proceeds.

^b Includes surtaxes imposed by all local government echelons. These are the only additions to national taxes authorized.

¹ Includes approximately thirty minor taxes levied independently by municipalities and villages plus surtaxes on specific prefectural taxes.

Faced with declining tax revenues, the Japanese government had resorted to successive annual increases in rates of existing taxes from 1942 to 1946, to the neglect of more fundamental tax reform or of strengthening tax enforcement. Whatever elasticity the tax system had possessed originally had long since been exhausted by rate increase following rate increase. By 1946, tax rates stood at peak levels. Marginal income tax rates affecting the majority of wage and salary earners started at 55 per cent. The top marginal income tax rate was 97 per cent. The admission tax rate was 200 per cent of the theater admission charge. Commodity tax rates were scaled from 50 per cent to 200 per cent ad valorem. Consumption taxes on restaurants, hotel lodging, and entertainment ran from 100 per cent to 300 per cent ad valorem. Despite such exorbitant rates, tax revenues continued their downward trend relative to national income and budgetary requirements.

The Extraordinary Tax Program of 1946

The "extraordinary tax program" was enacted in the Fall of 1946, and preceded the revision of the general tax system. The program essentially was built around two major non-recurrent taxes, the capital levy, and the war indemnity special tax.⁴

⁴ This program was based essentially upon the recommendations of Mr. Leo M. Cherne made in May, 1946. Mr. Cherne and his assistant, Charles J. Siegel, were requested by the War Department in early 1946 to aid in formulating the extraordinary tax program.

The major purpose of the capital levy was non-fiscal, as it was primarily designed to level off excessive concentrations of private wealth. Unlike the central European capital levies imposed following World War I, where main emphasis had been placed upon the retirement of a burdensome government debt or upon the financing of an extraordinary expenditure, the Japanese capital levy was couched largely in moral and socio-political terms. The levy was directed to the topmost 2-3 per cent stratum of Japanese society, a segment consisting almost exclusively of a class commonly referred to as the *Zaibatsu*.⁵ Through a network of highly integrated holding companies and combines, this class had come into virtual control of the whole of Japanese commerce and industry. Elimination of *Zaibatsu* power constituted one of the principal aims of the Occupation. As *Zaibatsu* holdings were concentrated at the peak of the wealth distribution pyramid, the selection of a sharply graduated capital levy seemed expedient to facilitate reduction of *Zaibatsu* power.

Fiscal considerations, while subordinate to the non-fiscal, nevertheless factored heavily in the adoption of the levy. The yield of the levy was set at 43.5 billion yen, equal to 120 per cent

of total 1946-47 general tax revenues, and to roughly 9 per cent of Japan's privately owned national wealth as of March, 1946.⁶

The capital levy was applicable to individuals owning real and intangible property, the net value of which exceeded 100,000 yen as of March 3, 1946. Household furnishings, clothing, and minor necessities were excluded. Corporations were exempt, as it was felt that such taxation would have involved multiple-taxation evils in their most objectionable form. Tax rates were graduated from 10 per cent on the first 10,000 yen of taxable net property in excess of the 100,000 yen exemption, to 90 per cent on that part of taxable property exceeding 15,000,000 yen. The incidence of the levy was made more burdensome by being applicable to family rather than individual property. The levy was measured by the net wealth of the household, while individual tax liability was distributed pro rata among its members.

Valuation problems were substantially mitigated by two features of the capital levy law. The first pertained to valuation of properties paid in kind. Since approximately half of the levy has been paid in the form of property, valued the same as when included in the measurement of the tax, problems of taxpayer underassessment were eased. Another feature of the law facilitating administration pertained to an extraordinary option granted the government. The government could purchase outright any property of a taxpayer for

⁵ The term *Zaibatsu* (*Zai*-financial, *batsu*-clique) had been generally used to denote some twenty-odd holding companies now being liquidated. The term is also associated with the "big four" family groups of Mitsui, Mitsubishi (Iwasaki), Yasuda, and Sumitomo. "It is the intention of the Supreme Commander to dissolve the private industrial, commercial, financial and agricultural combines in Japan, and to eliminate undesirable interlocking directorates. . . so as to . . . permit a wider distribution of income and of ownership of the means of production and trade. . . ." (Excerpt from par. 5 of SCAP memorandum to the Japanese government, "Dissolution of Holding Companies," November 6, 1945).

⁶ The net value of privately owned national wealth in Japan as of March 3, 1946 (the assessment date of the capital levy) was estimated at 495,423,000,000 yen by the Ministry of Finance. (Reported to the author by the Planning Section, Ministry of Finance.)

the original assessed valuation if the assessment was deemed inadequate. This option, while rarely exercised, is believed to have greatly facilitated the levy's administration.

Fiscally, the levy has been successful. Approximately 36 billion yen of tax liability had been voluntarily declared by taxpayers by February 15, 1947, the closing date for filing returns. Total capital levy assessments as of March 31, 1948, approximated 43 billion yen, slightly under the originally estimated yield of 43.5 billion yen. Collections as of the end of March, 1948, had amounted to 39 billion yen, representing 21 billion yen in cash and national bond payments, and 18 billion yen in the form of negotiable securities, real and personal properties.

The second element of the extraordinary tax program was the war indemnity special tax, which was enforced concurrently with the capital levy. The aim of the war indemnity special tax was essentially to extricate the Japanese government from a tremendous debt incurred during the war years.

During the war years, the Japanese government had underwritten practically every element of risk incident to private enterprise associated with the war. By V-J Day, the Japanese government was faced with a prodigiously large debt—80.9 billion yen of unpaid claims arising from war damage insurance, contract termination, indemnities for government ordered plant expansion, depreciation and obsolescence guarantees, and from other claims generally classified as "war indemnities," and 24.8 billion yen of claims from private banks for industrial loans in default, all of which has been guaranteed by the government.

Payment of this debt, aggregating 105.7 billion yen was well beyond the Japanese government's fiscal powers in 1946. Postponement of the debt appeared undesirable, as uncertainties concerning the ultimate validity of indemnity claims had already given rise to widespread industrial apathy. Outright repudiation of the debt, while popularly demanded, would have bankrupted the industrial and financial structure. The size of the indemnity claims amounted to more than twice the aggregate capital and surplus reserves of all corporations in Japan.

The solution undertaken by the Japanese government to rid itself of its wartime financial overhang was in effect a modified form of cancellation in the form of a 100 per cent "tax" at source. As of December 14, 1946, all wartime claimants against the government filed war indemnity special tax returns. Claimants were allowed designated exemptions per claim (generally 10,000 yen). The excess of each claim above the designated exemption was cancelled by the 100 per cent "tax." Claimants not filing with the government as of the filing date were "taxed" on the full amount of their claims. The tax also recaptured approximately 40 billion yen of claims that had been paid out in the form of blocked bank deposits between the war's end (stipulated as August 15, 1945, in the war indemnity special tax law) and the date of tax enforcement.

With the imposition of the tax, government indemnity and loan guarantee obligations were scaled down from 105.7 billion yen to approximately 15 billion yen, the latter representing the claims honored under allowable exemptions. The net "revenue" from the

war indemnity special tax may consequently be put at more than 90 billion yen.

As the scale of indemnity losses absorbed by industry greatly exceeded the net worth of the entire corporate structure, radical changes in ownership were inevitable. Ownership passed from shareholders to creditors in a major segment of heavy industry. Losses were chiefly concentrated in the munitions and heavy industries, and among larger financial institutions that had invested indiscriminately in such industries.

The imposition of the war indemnity special tax might well have been detrimental to chances for an early industrial recovery had it not been for various corollary measures enacted concurrently by the government. These were designed to cushion the impact of the tax, by making possible a continuation of normal business operation pending mass bankruptcy proceedings of firms left insolvent by the tax.

A principal device incorporated in the government's corollary measures involved the establishment of "second companies" by corporations made insolvent by war indemnity losses. To such second companies were transferred designated types of operating assets and liabilities from the old or mother companies. The latter, left as they were with the capital account, non-operating assets, and the bulk of the liabilities, were to undergo prescribed liquidation proceedings. Following the completion of liquidation, the two companies were again to merge as one.⁷

⁷ The Japanese government prescribed a uniform priorities system for the absorption of losses, under which losses were to be written off in the following order: (1) current business profits, surplus reserves, and asset revaluation profits; (2) capital stock up to 90 per cent of face value; (3) creditors, up to 70 per cent of claim values; (4) remaining shareholders equities; and (5) remaining creditor claims.

Another cushioning measure undertaken by the government was the establishment of a Reconstruction Finance Bank, the purpose of which was to offset stringent credit conditions attending the imposition of the war indemnity special tax. Credit on liberal terms has been extended to essential industry by this government-owned bank since November 9, 1946, when it began operations.

In assaying the war indemnity special tax, due recognition must be given to the conditions prevailing. Payment of the indemnity debt could only have been made by operation of the government printing press, and would have constituted an enormous inflationary stimulus. Payment, even if practicable, appeared contrary to public opinion. Cancellation of indemnities was favored upon moral grounds. It was generally contended that war indemnity losses would fall chiefly upon those elements in the economy who profited, or stood to profit, unjustly by the war. In adopting the war indemnity tax, the government merely formalized what was apparently a foregone conclusion on V-J Day.

Taxation Reforms, 1947-48

Following the enactment of the war indemnity special tax and the capital levy, attention was directed toward revising the general tax structure. The desired objectives in this revision were, in the order of importance: (1) much higher tax productivity, so as to make possible a balanced budget for fiscal 1947-48; (2) a tax system of greater counter-inflationary impact, and one more responsive to rapidly changing economic conditions; and (3) a more equitable distribution of taxation incidence. Salient features of the current tax structure, as revised by the statutory

reforms undertaken in March and November, 1947, are described below.

The Personal Income Tax.—The personal income tax embodied revolutionary changes in both form and administration. Perhaps the greatest innovation for the Japanese taxpayer was the adoption of a current payment basis for the personal income tax. Withholding at source, previously limited to normal tax liability on salary and wage income, was increased in scope to cover full income tax liability. Withholding at source on corporate dividends, and bond and bank deposit interest earnings, was made mandatory at a flat rate of 20 per cent. Individuals receiving taxable income not subject to withholding were also placed on a pay-as-you-go basis, through the medium of advanced quarterly income declarations and payments of estimated annual tax liability.

An interesting feature of the Japanese withholding system is its final adjustment mechanics. As in the United States, the withheld tax is subject to final adjustment at the year-end. Unlike the American practice, however, the bulk of year-end adjustments are practically settled by the employer rather than by the government. At the end of the calendar year, the employer compares the actual amount of wages withheld with the amount of tax liability due on the aggregate wages paid to the employee for the entire year, as shown by a short form income tax table. If the withheld amount is less than the indicated liability, the employer withholds the difference during the following pay period. If the amount withheld exceeds the adjusted tax due, the employee receives a withholding credit applicable against the next withholding period.

It is noteworthy that a final return as known in the United States is not required in Japan. Quarterly estimates of the annual tax liability, and payments thereon, are due by the last day of May, July, October, and January. Taxpayers may revise their tax estimates at any time during the year, and make necessary adjustments on tax payments. The fourth quarterly return, due January 31, serves also as the final return.

Capital gains from intangibles as well as tangibles were made taxable under the 1947 income tax law. Although the scope of what constitutes a capital gain is now practically identical for the United States and Japan, a number of significant taxation differences may be outlined. Where a short-term and long-term differentiation is made in the United States, it is not in Japan. Where an alternate tax on capital gains is offered in the United States, 50 per cent of the value of all capital gains is taxable as other income in Japan. Capital loss carry-overs are not allowable in Japan; capital losses may be offset only against gains for the same taxable period. In the United States, five-year loss carry-overs are currently permitted, as well as the writing off of capital losses against other income up to \$1,000 in any one year. Lastly, it is noteworthy that capital gain liability in Japan is not avoided when appreciated assets are transferred at death or by *inter vivos* gifts. Under the Japanese law, the full value of a capital gain accumulated over several generations becomes taxable at the time of sale of the capital asset. By establishing the basis of an appreciated asset when sold by an heir or donee as the cost to the decedent or donor (or to the last preceding owner by whom it was not acquired by gift

or inheritance), Japan seeks to avoid the wiping out of capital gains liability at death or by gift.⁸ The provision may prove too difficult to administer, however, when more than one transfer is involved.

Computation of the tax under the 1947 law was greatly simplified. A single graduated rate scale applicable to all income forms has been substituted for the earlier plethora of differentiated normal and surtax scales.⁹ The following rates apply to successive increments of taxable net income:

Taxable Income in Yen	Tax Rate
Under 10,000	20%
10,001- 15,000	25
15,001- 20,000	30
20,001- 30,000	35
30,001- 40,000	40
40,001- 50,000	45
50,001- 70,000	50
70,001- 90,000	57
90,001- 120,000	64
120,001- 150,000	68
150,001- 200,000	72
200,001- 250,000	76
250,001- 300,000	80
300,001- 500,000	82
500,001-1,000,000	84
over 1,000,000	85

Earned incomes are given preferential tax treatment in the form of a 25 per cent reduction from gross earned income, up to a maximum annual deduction of 12,500 yen. For three specified

⁸ This coincides with current United States tax practice regarding capital gain basis for gifts acquired subsequent to December 31, 1920. See Internal Revenue Code, sec. 113 (a) (4) and Regulations, sec. 29.113 (a) (2)-1. Constitutionality upheld by Supreme Court: *Taft v. Bowers*, 278 U.S. 470; *Cooper v. U.S.*, 280 U.S. 409.

⁹ Differentiation of income for tax computation under the 1940-46 income tax law was both administratively cumbersome and inequitable in practice. Normal tax computation involved the division of taxable income into a dozen or more source classes and the computation of tax liability separately for each class.

sources of income, capital gains, forestry income, and retirement annuity income, a 50 per cent reduction is allowed in computing taxable income. No personal deductions other than a basic personal exemption of 4,800 yen per annum per taxpayer are permitted. A credit against tax of 480 yen per annum is allowed for each dependent.

Transition to Pay-as-You-Go Income Taxation.—In shifting the personal income tax to a current payment basis, a problem arose concerning forgiveness of 1946 income tax liabilities due during 1947. Whereas 1946 normal income taxes on earned income had been collected at source during 1946, all remaining tax liabilities on 1946 income were still outstanding. The problem was solved by the enactment of the increased income tax act of December, 1946. This act, which provided for complete forgiveness of all 1946 tax liabilities due during 1947, also provided for a one-time progressive tax upon substantial excesses of 1946 over 1945 personal incomes, exclusive of earned income. The increased income tax was primarily designed to deprive individuals who derived unusually high incomes during 1946 from enjoyment of an unfair tax advantage resulting from the forgiveness feature. The tax was imposed during April, 1947, with rates graduated from 30 per cent to 90 per cent.

The Estate and Gift Tax.—The estate and gift tax law was enacted in March, 1947, and became effective May 3, 1947, simultaneously with the abolition of the earlier inheritance tax and the enforcement of Japan's new constitution. Although gift and death taxes are not as yet integrated, this possibility is currently under consideration.

The estate tax component incorporates features normally found under the inheritance form of taxation. While the base of the tax includes the entire estate, the effective rate varies in accordance with the degree of relationship between respective heirs and the decedent. Tax rates are established in three different scales, based upon the relationship of heir to decedent, and are graduated from 10 per cent to 60 per cent, 13 per cent to 63 per cent, and from 15 per cent to 65 per cent. A basic exemption of 50,000 yen is permitted. Charitable, educational, and scientific contributions are excluded from the tax base up to 10 per cent of the net value of the estate, or 100,000 yen if smaller.

Some safeguards against death tax avoidance through life-estate-remainder and trust devices were provided in the law. The value of all property rights or property enjoyment passing to another person at the decedent's death is included in the value of the estate, according to a statutory provision. This and other provisions of the law were intended to bring transfers of property rights taking place at death, whether by will, revocable or irrevocable trusts, powers of appointment, or life-estate-remainders, into the estate tax base.

Gift tax rates are graduated from 15 per cent to 65 per cent. A basic lifetime exemption of 50,000 yen, the same as that of the estate tax component, is given. Gifts valued at less than 3,000 yen per donee per calendar year are excluded from the gift tax base. Gifts made within a two-year period prior to the decedent's death are automatically presumed to have been made in contemplation of death, and are included

in the estate tax base. Gift tax concessions for charitable, educational, and religious donations are also limited. Such contributions up to 100,000 yen in the aggregate are 50 per cent tax exempt.

Corporation Tax.—The 1947 corporation tax law included four distinct tax bases, as follows:

Tax Base	Tax Rate
(1) Net income	35 %
(2) Capital stock and surplus reserves	0.5
(3) Excess profits:	
Net earnings exceeding 10 per cent of capital employed ...	10
Net earnings exceeding 20 per cent of capital employed ...	20
Net earnings exceeding 30 per cent of capital employed ...	30
(4) Liquidation proceeds (excess of proceeds at liquidation or amalgamation above face value of capital stock)	25-45

Net income is defined as gross profits during any accounting period minus gross losses. A one-year carryover of operating losses is permitted. No component of the corporation tax may be included as loss or expense in computing taxable net income. The effect of this is to add graduation to net income tax rates. Thus the tax on corporate net income begins at 35 per cent where no excess profits are realized, and progresses successively to 45 per cent, 55 per cent, and 65 per cent.

Although corporate excess profits were formerly based upon average base period profits, the 1947 corporation tax prescribes the ratio of profits to capital employed (capital stock and surplus reserves) as the sole excess profits base. Dependence on this single base has obviated considerable administrative complexities, although it undoubtedly has given rise to discrimination against low capitalization industries. The continuation of excess profits taxation in

the postwar period was prompted by the unusually large profits derived by many corporations through inventory revaluation and speculative hoarding of materials in anticipation of further inflationary advances.

Special provisions are applicable to closely-held or family corporations. Where 50 per cent or more of a corporation's shares are held by a stockholder or a member of the corporation and his relatives, the corporation comes under the provisions of chapter VIII of the corporation tax law. A special undistributed profits tax is imposed upon such designated corporations, thereby adding a fifth component to the corporation tax. A graduated tax, ranging from 35 per cent to 75 per cent, is imposed upon undistributed profits in excess of one-third of realized profits for each accounting period.

The Japanese have until recently regarded corporations as distinct legal entities, and the question of personal and corporate income tax integration has hitherto never received serious consideration. As this is being written, however, the Japanese government has introduced legislation providing for: (1) elimination of the capital stock tax; (2) revised excess profits tax rates starting at 10 per cent of annual net earnings above 30 per cent of invested capital and running to 20 per cent on that portion of annual net earnings exceeding 100 per cent of invested capital; and (3) a credit against personal income tax liability amounting to 15 per cent of personal dividend income.

Three factors are responsible for this fundamental shift in the concept of business taxation. First, the existing corporate tax structure has been widely criticized for its repressive effects upon

urgently needed capital formation and industrial production. (Excess profits tax rates, while limited to corporations earning profits in excess of 10 per cent of invested capital, were actually applicable to more than three-fourths of all Japanese corporations showing positive net earnings in 1947, owing primarily to widespread corporate undercapitalization.) Second, a corporate tax structure more conducive to the attraction of foreign capital was desirable. Third, a liberalized corporate tax system was in line with the Japanese government program to divest itself of more than 25 billion yen of corporate shares (approximately 50 per cent of all corporate stock outstanding) acquired through enforcement of the capital levy, war indemnity special tax, and various anti-trust laws.

The flat 15 per cent tax credit for dividends should be viewed as a transitory measure rather than as the final version of corporate and personal tax integration. In order to minimize the initial investment market shock, Japanese government tax planners envisage a two to three year gradual approach to a more complete form of integration. While the precise final form of corporate-personal tax integration has not as yet been agreed upon, opinion favors adoption of a modified form of partial integration patterned largely along the lines of current British practice. It is noteworthy that the timing of tax integration is particularly opportune. The volume of dividend earnings is currently very low, totalling less than 400 million yen in 1947. Another favorable factor is that the windfall gains resulting from integration would accrue largely to the Japanese government, by virtue of the latter's tempo-

rary ownership of a major portion of the corporate stock issue. Because of these two factors, the initial revenue impact of integration is likely to be negligible.

Non-War Sufferers' Special Tax.—The non-war sufferers' special tax law was enacted in November, 1947, for the express purpose of shifting a greater share of the tax burden upon those whose real properties escaped air-raided damage during the war. The tax was imposed on a non-recurrent basis, due January 31, 1948, upon both the owners and tenants of buildings, in inverse proportion to the extent of war damage sustained. While the express purpose of the tax was to spread property damage burdens on a wider scale, a more realistic aim of the tax was to increase the tax burden upon real property. In sharp contrast to the former important role of real property taxes in the Japanese tax system, the contribution of real property taxes had declined to less than 2 per cent during fiscal 1946-47. Until the prevailing low levels of property assessments could be brought up to more realistic values (scheduled for 1948-49), interim special taxes on real property appeared feasible.

Other Statutory Changes.—The pattern of indirect consumption taxes was substantially altered for fiscal 1947-48, compared with previous distributions. Indirect taxes were selectively increased. Ad valorem excises on most manufactured commodities were substantially reduced, while specific levies such as those on liquor, beer, and wines were increased to the point of securing maximum possible revenue from such sources. As noted in Table 3, the relative importance of revenues from liquor, beer, sake, horse-racing, and

theater admissions increased from a total contribution of 10.3 per cent in fiscal 1946-47 to 19.4 per cent in fiscal 1947-48. The more regressive forms of consumption taxes, such as the commodity tax and textile excise, declined from a contribution of 10.0 per cent to 6.2 per cent in the same period.

The taxation powers of local governments were considerably expanded for 1947-48, in line with a desire to make local governments less dependent financially upon national government subsidies. The business, land, house, mining rights, and amusement and recreation taxes, levied by the national government during 1946-47 and prior years, were transferred to local government exclusive use at the end of March, 1947. These transfers of taxation sources, plus upward adjustment in maximum rates,¹⁰ made possible a 46 per cent increase in the relative importance of local government taxes to all taxes from 1946-47 to 1947-48 (see Table 3).

Administrative Reforms, 1947-48

It was readily apparent that the weakest link in the plan for attaining a fiscally adequate and more equitable tax structure in 1947-48 was in enforcement of the revised tax statute. Taxpayers would necessarily have to be completely reoriented with respect to new tax responsibilities under self assessment of the pay-as-you-go personal income tax, non-war sufferers' special tax, increased income tax, and estate and gift tax. Moreover, tax collection machinery would have to be geared to attain almost twice the preceding year's

¹⁰ Local as well as national tax laws are enacted by the Diet. Legal maximum rates for local government laws were substantially raised by Diet action in March, 1947.

scale of revenue, relative to national income, during 1947-48.¹¹

A drastic reformation of taxation customs in one year would constitute a formidable undertaking in any nation, much less a nation as steeped in tradition and as subservient to the status quo as Japan. For decades prior to 1947, taxpayers and tax collectors became accustomed to an unwritten code regarding tax assessment and payment. Assessment was strictly a government function, one in which the taxpayer took little part. Taxpayers, while nominally required to furnish income particulars, rarely did, and paid no penalty for failing to do so. Appeals for reconsideration of assessments handed down by government imputation were rare, as assessments were invariably far below realized incomes. Thus, taxpayers were under little compulsion either to report actual incomes, or to correct the tax collector's arbitrary assessment of same.

One reason for the lack of response of income tax revenue to upward adjustment of rates lay in another quaint Japanese custom of tax assessment. Taxes were generally assessed "backwards." The amount of tax any taxpayer was expected to pay was first arrived at, generally based upon previous tax records and of what was known of the taxpayer's consumption for the taxable period. Formal computation of tax then followed, wherein taxable net income would finally be determined.

While arbitrary, tax assessments were by no means impartial. The reliance

of Japanese tax authorities upon ex officio "tax investigation committees" was another disturbing peculiarity of the Japanese tax administration. Composed of local electees for terms of four years, these committees were primarily responsible for delivering "first approximations" on income and other tax assessments within their community. Voting for committee members was restricted to taxpayers, and it was noteworthy that only the wealthier and more influential residents displayed more than a passive interest in sponsoring and electing candidates. Thus, the most important work in tax administration was relegated to local electees, who served without official compensation, who were generally untrained in tax matters, who were nominated and elected by the same elements in the community whose tax liability was to be most affected, and who were widely known to be open to bribery.

Enforcement of the tax laws was notoriously weak. Not a single case of conviction or punishment for tax evasion had ever been recorded in Japan until November, 1947. When questioned on this point by the author, certain Japanese officials replied that criminal punishment for tax evasion was contrary to Japanese ethics. Collection of the evaded amount of tax was deemed sufficient "punishment." Under 1946 and earlier tax laws, furthermore, it would have been extremely difficult for the government to prove evasion or fraud. At any time prior to actual indictment, a suspected tax evader could have confessed his guilt, paid the evaded amount, and absolved himself from further "punishment."

Concurrently with the revised statutory changes in March, 1947, remedial

¹¹ National income for fiscal 1946-47 and 1947-48 was estimated at 400 and 1,000 billion yen respectively by the Finance Ministry. Thus, the percentage of tax revenue (excluding tobacco profits) to the national income approximated 8.25 per cent for 1946-47, and 15.86 per cent for 1947-48.

action was taken to achieve more vigorous enforcement of taxes along with more equitable methods of income assessment. Civil service career employees were substituted for ex officio assessment committees. A corps of special revenue agents was organized to enforce the more stringent penalties included in the revised tax laws. A comprehensive publicity campaign was undertaken to acquaint the public with self-assessment procedures. An informer reward system, whereby informers were rewarded up to 10 per cent of the amount of evaded taxes collected was also adopted. The success of these administrative and enforcement reforms can best be attested to by the level of actual tax collections in fiscal 1947-48.

Early concern over whether the full amount of the expanded scale of taxation budgeted for fiscal 1947-48 could be collected had been well founded. By December 31, 1947, with nine months of fiscal 1947-48 elapsed, the total amount of taxes collected stood at 46.5 billion yen. This represented only 34.4 per cent of the 135.39 billion yen of tax revenues budgeted (see Table 3). The principal reasons for the disappointingly low collection levels were: (1) the filing of greatly understated income tax self-assessed declarations, apparently in anticipation of upward reassessment by tax officials; and (2) administrative lethargy in enforcement of new penalty provisions.

Alarmed over the prospect of a huge deficit in budgeted tax revenue, the Japanese government launched a greatly intensified publicity and enforcement drive in early January, 1948. Newspapers, radio, motion pictures, posters, pamphlets, public forums, and other publicity media were all mobilized to

bring home to the public their stake in the tax collection program. More vigorous enforcement of tax penalty provisions was particularly emphasized in publicity material. Direct orders were handed down by the Ministry of Finance to the nation's 450 field tax offices to enforce the penalty provisions embodied in the revised tax laws, or to face disciplinary action for failure to do so. Instructions were issued to attach and sell at auction the property of all delinquent taxpayers as of the end of January, 1948. Indictments were handed down in more than 100 cases of alleged tax evasion, representing the first time in tax enforcement that court prosecution was utilized. Reassessment notices were issued to more than 80 per cent of the taxpayers filing self-assessed income declarations, the magnitude of reassessment often running three to four times the tax originally computed by the taxpayer.

In view of the critical importance of the tax collection drive, Allied Military Government forces were also assigned a role in bolstering tax collections. Fifty special military government teams, each headed by an officer detailed from the legal department of the prefectural military government teams, were organized in late January, 1948, and assigned to surveillance of Japanese tax collections exclusively. While not participating directly in tax collection, military government tax surveillance teams sought to impress upon both taxpayers and tax collectors the importance of taxes in arresting inflationary pressures. As the Japanese government has been prohibited from operation of aircraft, Allied aircraft were employed during February, 1948,

in distributing hundreds of thousands of tax leaflets and instruction sheets over Nara, Aichi, and Kagoshima prefectures. The major benefit derived from military government surveillance of tax administration was the added prestige given tax administration. The mere presence, periodically, of Allied officers in Japanese tax offices was often sufficient to bring about an extraordinary expansion in tax collections in the area.

The results of the intensified drive, measured in terms of actual tax receipts, were phenomenal. Collections rose from the April - December, 1947, monthly average of 5.2 billion yen to 16.8 billion yen in January, 32.1 billion yen in February, and 25.5 billion yen in March, 1948. Aggregate 1947-48 national government tax collections in relation to the budget estimate of 135.39 billion yen are shown in Table 4.

TABLE 4
NATIONAL GOVERNMENT TAX COLLECTIONS IN
RELATION TO BUDGET ESTIMATE, JAPAN,
FISCAL YEAR 1947-48

Period, April 1, 1947, to	Aggregate Tax Collections (in Billions of Yen)	Per Cent of Budget Estimate
December 31, 1947	46.5	34.4
January 31, 1948 ..	63.3	46.8
February 28, 1948 .	95.4	70.5
March 31, 1948 ..	120.9	89.3
April 10, 1948	130.1	96.2
April 30, 1948 ^a ...	139.7	103.2

^a Estimate. Although the fiscal year ends March 31, under Japanese government fiscal practices a carryback of a part of April and May tax collections to the preceding fiscal year is normally made. The carryback reflects (1) a fifteen-to-twenty day lag in reporting of tax collections to the treasury, and (2) taxes assessed in the preceding fiscal year and paid during April or May.

Despite the extremely low levels of collections prevailing throughout the first three quarters of fiscal 1947-48, actual

tax collections are presently expected to slightly exceed the budget estimate.

Summary

The attainment of 139.7 billion yen in Japanese national government taxes in fiscal 1947-48 denotes a marked improvement in the productivity of the tax system. As noted above, actual national government tax receipts (excluding tobacco profits) totaled 29.7 billion yen in fiscal 1946-47, corresponding to 7.4 per cent of the estimated 400 billion yen national income. In fiscal 1947-48, actual tax receipts of 139.7 billion yen constitutes a 13.97 per cent absorption of the estimated 1,000 billion yen national income. The expansion in the national tax load is even more marked when local government taxes and Japanese government monopoly profits on tobacco are additionally considered (see Table 5).

TABLE 5
TAXES AND NATIONAL INCOME, JAPAN, FISCAL
YEARS 1945-46 to 1947-48
(Amounts in Billions of Yen)

	1945-46	1946-47	1947-48 ^a
1. National government tax receipts	10.5	29.7	139.7
2. National government profits on tobacco	1.1	7.7	40.0
3. Local government taxes	1.0	3.3	23.2
4. Total tax load (1 + 2 + 3)	12.6	40.7	202.9
5. National income .	155.0	400.0	1,000.0
6. Total tax load as a per cent of national income ..	8.1%	10.1%	20.3%

^a Estimate.

Relative to budget appropriations, 1947-48 revenues also indicate a substantial improvement. As noted in Table 1, 1946-47 Japanese national government revenues financed 46.0 per

cent of budget expenditures. Present revised 1947-48 revenue estimates total 197.8 billion yen, representing 93.3 per cent of budget appropriations totaling 214.3 billion yen.

The deflationary impact of the expanded tax scale has been mirrored in the sudden arrestment of currency increase (see Table 2). For the first time in over six years, the currency issue has been held substantially level for an entire quarter. While by no means conclusive evidence of an end to inflationary pressures, the leveling off of the currency curve does indicate a sharp

contraction in Japanese government resort to the printing press to finance recurring deficits.

Japan's postwar taxation reforms represent an ambitious undertaking designed to facilitate Allied Occupation objectives and to hasten internal economic stabilization. The experiment is especially noteworthy from a purely fiscal standpoint. It indicates that a doubling of a nation's tax burden can be achieved in a relatively short time, even in a nation which has historically operated on a fairly low scale of taxation.

TREASURY TAX STUDIES, I

CATHERINE RUGGLES GERRISH *

DURING 1947 and 1948 the Treasury Department has issued a series of tax studies concerned with various aspects of postwar tax revision. Practically all the studies are in mimeographed form, but many of them have been printed in the hearings of the Committee on Ways and Means. On the whole, they consist of factual and analytic information, and with only a few exceptions, make no policy recommendations. Much valuable statistical material is included. Comparisons are made in numerous instances with experience in foreign countries. The studies are concerned with aspects of the taxation of business, personal income taxation, Federal estate and gift taxes, extension of the social security system, various excise taxes, and Federal-state tax coordination.

Studies such as these should be very helpful to Congress in formulating tax policy inasmuch as they bring together in one place information bearing upon a particular problem and present various sides of the issues involved. Since each of these studies is devoted to a single topic, however, none of them takes an over-all view of the tax structure. The latter is badly needed and it is to be hoped that it will be supplied by the Tax Policy Consultant Group appointed by the Treasury in 1947 to formulate a program of tax revision.

* The author, who now resides in Cambridge, Massachusetts, was formerly a member of the faculty of the University of Illinois and of the staff of the U.S. Bureau of the Budget.

The taxation of business, in particular—the economic considerations involved therein, the issues of equity to owners of business, whether incorporated or unincorporated, and of equity to consumers of goods and services—is in need of more consistent treatment than it has received in our tax system or in this excellent series of studies.

1. BUSINESS TAXES

Corporation Tax Structure

*The Postwar Corporation Tax Structure*¹ by Richard B. Goode, the only signed study in the series, is devoted to the corporate income tax, its underlying philosophy, its effects, various alternative taxes, and the proper timing of changes. Some very ingenious and informative charts are included which show the combined weight of the individual and corporate income taxes as a percentage of corporate profits when varying amounts of corporate profits are retained, under the present system and under each of the proposed systems. The arguments for and against the corporate income tax are discussed together with the problem of incidence. Although account is taken of the possibility that the tax may be shifted to prices or wages, the assumption throughout most of the study is that generally made

¹ December, 1946. Pp. v + 79. Reprinted in *Revenue Revisions, 1947-48*, Hearings before the Committee on Ways and Means, House of Representatives, 80th Cong., 1st Sess. [cited hereafter as *Hearings*], pp. 1136-1181.

by economists, that the tax is not shifted but rests on the stockholder.

The criticisms of the tax center around its inequity and its economic effects. The tax is held to be inequitable because, first, it results in dividend income being taxed more heavily than other income, and, second, it bears more heavily on low income groups inasmuch as taxation of all corporate income means that dividends of low income stockholders are taxed at the same rate as dividends of high income stockholders. Whether the double taxation of dividends is not given too much emphasis both in this study and in much of the current literature on the subject may well be asked. The potential investor is aware of the corporate income tax, and presumably buys stock only at a price which is satisfactory to him in view of probable future earnings after taxes. If all stockholders had purchased their stock since 1942 when the 40 per cent rate was imposed, the problem of the equity of the tax would not be serious. It was only individuals who owned stock before the imposition of the corporate income tax of 1909 who were injured by the imposition of the tax at that time. Similarly, after 1909 the equity of the tax was a function of changes in the rate rather than of its mere existence. For example, if it could be supposed that the tax had reached its maximum, the equity of the tax would no longer be a serious problem except to the extent that reductions would be accompanied by windfall gains. The study notes that after imposition of a corporate tax, "Price adjustments will not be confined to stocks, but will extend to other assets," and recognizes that "in the long run, taking into account probable changes in

the prices of assets, the corporate tax is more likely to result in general reduction of investment yields from all sources than in specific 'double taxation' of dividend income." (p. 7) But for reasons which are not apparent, perhaps because the long run is assumed to be so long as to be without significance for most stockholders, this argument is given little consideration. For double taxation to be of much importance, a large proportion of stockholders would have to have bought their stock when the corporate income tax was much lower than it now is. But the study seems concerned over windfall gains to stockholders, and such gains could accrue only to stockholders who took account of the present tax when they purchased stock.

The problem of equity is two-sided as seen in this study: "One side is elimination or reduction of 'double taxation,' that is, keeping corporate profits from being taxed more heavily than other kinds of income. The other side is prevention or limitation of tax postponement and avoidance, that is, keeping corporate profits from being taxed less than other kinds of income." (p. 64) The latter statement, however, is inaccurate since some stockholders would be taxed at less than the rate of the corporate income tax or not taxed at all, if all earnings were distributed.

The corporate income tax has been variously described as proportional, progressive, and regressive. The tax appears to be proportional inasmuch as, "The corporate tax reduces dividend income which could be retained by a stockholder after individual income tax by the same percentage in every income bracket." (p. 9) On the other hand,

the tax is often held to be progressive because dividends constitute a larger proportion of income among high income groups than among low income groups. But when the corporate income tax and the personal income tax are considered together, the corporate tax appears to be regressive. To the extent that the corporate income tax reduces dividends, individuals in the lower income brackets are deprived of more income proportionately than individuals in the higher income brackets, since most of the dividends received by the latter would have to be paid out in income taxes. The attitude of the study is summed up in the statement that, "With present rate schedules, the individual income tax is more progressive than the corporate tax, more uniform among individuals in the same income group, and hence by usual standards more equitable." It might have been mentioned, however, that to the extent that the corporate tax has been capitalized and stockholders have purchased stock free of tax, all the discussion about the burden of the tax and about whether it is proportional, regressive, or progressive is beside the point.

The economic consequences of the tax have also been the subject of much debate both as regards the effect on methods of corporate financing and the effect on investment. There is no doubt about the tax being a deterrent to equity financing. It is, of course, only one of various factors to be weighed in a choice of methods of financing, and statistical data, as shown in the study, give little indication of what the effect of the tax has actually been. Proponents of the tax argue that it has a desirable effect on investment because "it reduces consumption

less and savings more than would feasible alternative sources of revenue." (p. 17) Critics of the tax, on the other hand, believe that it has an unfortunate effect on investment, both directly and indirectly. The tax limits capital from security sales and from retained earnings available for investment. It reduces the willingness to invest on the part of individuals and of management, particularly so far as risky ventures are concerned because of the problem of loss offsets. But even if the law allowed complete loss offsets and income existed against which to offset losses, the tax would reduce income below the minimum return necessary in some cases. For "some part of the 'net income' subject to Federal corporation income tax is actually a return necessary in the long run to induce continued operation and expansion," (p. 3) and "the corporation tax will always in some cases infringe upon that minimum return." (p. 12) It is likely though, as frequently pointed out in the study, that alternative taxes would not be free from all these defects either.

Four basic approaches for taxing corporations are suggested and analyzed. All of them would involve some loss of revenue, the loss being greater the more the departure from the present system, or the more nearly alike the taxation of corporate income and other income. The first would abolish the corporate income tax completely and stockholders would be taxed as partners or at regular personal tax rates on distributed and undistributed profits. The second would eliminate the corporate income tax entirely and would adopt full taxation of realized capital gains at regular individuals rates. The third, the credit-

for-dividends-paid approach, would make an adjustment for distributed profits at the corporate level by reducing the corporate tax when profits were distributed. The fourth "would adjust stockholders' taxes to take account of the fact that corporations have paid taxes on profits from which dividends are distributed." (p. 64) Three variations of this last method are presented: the withholding tax approach, the dividends-received-credit approach, and the plan for the partial exclusion of dividends received from individual taxable income. Under any of these four basic proposals dividend income could be taxed equally with other income and the double taxation of dividends would no longer be a matter of concern to anyone. Only under the first method, the partnership approach, however, could undistributed profits be treated like other income. The partnership approach probably would have to be restricted to corporations with simple capital structures and a relatively small number of stockholders. It might be necessary in some cases for stockholders to sell their stock to pay the tax, and the lack of a ready market for some stocks would be embarrassing. Furthermore, the assumption that stockholders' economic power increases in close relation to retained earnings is questionable. According to information presented in the study, "stock prices do not increase in close correspondence with growth of the corporation's assets." (p. 33) Moreover, "Even if stock prices did reflect undistributed profits, it would be a departure from usual practice to treat such unrealized gains as taxable income." (p. 33) The capital gains approach would be inequitable because it

would involve a "seriously defective method of taxing undistributed corporate profits." (p. 27) "One kind of savings would be free from current taxation" and the way would be opened for "a great deal of individual tax postponement." (p. 27) The other methods would lessen whatever double taxation of dividends exists but not all of them would lessen it proportionately for all income groups.

The effect of the different methods proposed upon investment is found to be much less clear than their effect upon equity. The first two methods, which would abolish the corporate tax completely, would, of course, remove the disadvantages of equity financing. However, under the partnership method by which individuals would be taxed at personal rates on both distributed and undistributed profits, "individuals might hesitate to acquire shares in growing corporations likely to wish to retain a considerable part of their profits." (p. 35). Under the capital gains methods in particular it is probable that individuals would be stimulated to purchase stock because corporate savings would be free of any tax for a period of time. The credit-for-dividends-paid plan "would make stock more attractive to many individuals" insofar as it meant additional dividend payments. (p. 45) However, to the extent that it meant smaller retained earnings, it would make stock less attractive to high-income stockholders. The plans which make adjustment at the individual level for the payment of taxes on dividends by the corporation might stimulate purchases of stock. Two variations of this approach, the dividends-received-credit-plan and, to a much

greater extent, the plan for partial exclusion of dividends received from individual taxable income, would stimulate purchases by wealthy individuals inasmuch as these plans would be especially advantageous to those groups.

As for the effect on investment by corporate management, corporations lacking access to national capital markets, and other corporations also, could retain larger amounts of profits under the partnership approach since they would have to pay no income tax on corporate earnings. However, increased pressure for dividend distribution might make the retention of earnings more difficult. Under the capital gains approach corporate investment would be stimulated by being freed of any tax on earnings at the corporate level. The credit-for-dividends-paid plan might stimulate investment on the part of corporate management by the reduction of taxation of corporate profits, which would make investment opportunities seem more profitable. On the other hand, it might lessen it for large corporations which would be forced to go through the market. It is concluded that in general the plans which would make adjustment at the corporate level would probably have a more stimulating effect on corporate management than those which would make adjustment at the individual level.

A more complete comparative evaluation of these methods as a whole would have been desirable. It would appear that the two methods which would abolish the corporate income tax completely should be ruled out because the one, the partnership method, would be clearly impractical, and the other, the capital gains method, would be definitely inequitable. The possibilities for

change, accordingly, would be limited to the plans which would adjust at either the corporate or the individual level for the payment of corporate income taxes. Under these plans it would be possible to meet the argument in regard to the double taxation of distributed profits, but the taxation of undistributed profits would still be a problem. The disadvantages of equity financing would probably be a factor in all these plans. Just what the net effect of any variations of these methods would be on investment is difficult to say and would involve weighing the reactions of both individuals and corporate management. Furthermore, as reiterated frequently in the study, unless revenue requirements are suddenly reduced, no estimate of the equity or of the economic effects of any change is possible without reference to the effects of alternative taxes.

Intercorporate Problems

*Consolidated Returns and Intercorporate Dividends*² reviews the history of the taxes on consolidated returns and intercorporate dividends and the justification for them. Proposals are considered for changing the base of the tax on consolidated returns and the test of affiliation, and for making such returns compulsory, but all these proposals are found to be attended by difficulties. Although the use of the consolidated return is now penalized by a 2 per cent tax, such returns were originally required in the collection of the excess profits tax of World War I to prevent tax avoidance and evasion. Since the consolidated return brings substantial savings which accrue primarily to big business, it has been an issue in the dis-

pute over industrial concentration and has been alleged to contribute to the decline of small business. On the other hand, it is maintained that an affiliated group of corporations is actually a single economic enterprise, the economic results of which can be seen only on a consolidated statement. That any rate of tax on consolidated returns is arbitrary is generally agreed. An investigation was made to "relate the existing tax of 2 per cent of the consolidated surtax net income to the savings from consolidation." (p. 11) A sample of 215 consolidated 1943 tax returns was studied. Approximate tax reductions were estimated and related to consolidated adjusted net income. "The results indicate . . . that there is no consistent percentage relationship between 'savings' and consolidated net income which is typical of the group as a whole. Some large tax savings appeared where there were heavy loss offsets and the consolidated firm had little net income. Moreover, there is not a single case in this sample where the savings are precisely 2 per cent of consolidated net income." (p. 12) Tax savings result from avoidance of the tax on intercorporate dividends and from the offsetting of losses. Insofar as the lowering of the tax results from the offsetting of losses the crux of the problem is that "the special advantage of the affiliated corporation is reduced to the fact that it can realize an immediate offset while the non-affiliated corporation which cannot absorb the loss by a carryback merely has a contingent offset against possible future profits." (pp. 10-11)

The main purpose of the tax on intercorporate dividends has been to discourage the concentration of corporate

ownership and the split-up of corporations to avoid the graduated corporate net income tax. It "falls indiscriminately on all corporations holding securities of other corporations irrespective of their structure and the nature of their business. Insurance companies, banks, and other investment institutions are given the same treatment as holding companies whose operations are much more likely to contribute to monopoly. No account is taken of the fact that legitimate business reasons, such as the requirements of State law or the opposition of minority stockholders, may compel multiple incorporation for many affiliated groups."

(p. 2) It is questionable how effective the tax is in discouraging the concentration of corporate ownership. Although it is probably of some importance, other factors undoubtedly weigh much heavier. In fact, it might have been pointed out that in some cases the tax on intercorporate dividends might foster the purchase of stock of one corporation by another. For example, if a company already owns a considerable portion of another, it may be encouraged to acquire 95 per cent of the stock of the latter in order to file a consolidated return and thus be entirely free from the taxation of intercorporate dividends. As for the effect of the tax in preventing the splitting-up of corporations, "in most instances, the type of organization will be determined primarily by business needs rather than the desire to reduce taxes, and . . . even though the latter factor sometimes plays a considerable role in the decision, it is rarely of primary importance."

(p. 3) Moreover, it is noted that any effect which the tax may have had in

preventing the splitting up of corporations has been greatly lessened by the increased graduation of the corporate income tax structure since 1935. One of the most common considerations in the splitting up of corporations, which might have been mentioned, is the desire to secure the advantage of limited liability for the carrying on of diverse activities. If a new venture were to be carried on within a corporation already doing an established business, and large losses were incurred, the whole corporation might be wiped out.

Loss Offsets

*Business Loss Offsets*³ discusses the importance of loss deductions, problems of equity, revenue, and administration, and recommends a change in the law. The purpose of the loss carryover "is to define and tax net income as correctly as possible over time so that different taxpayers will receive equal treatment." (p. 11) While it is recognized that loss offsets are highly desirable to "remove the impediments to risk taking and to increase the counter-cyclical effect of taxes," further explanation of the relation of loss offsets to risks would have been helpful to Congress. The relative merits of carrybacks and carryforwards are discussed and it is recommended that the two year carryback be repealed and a five year carryforward be enacted. The claim that the carryforward would be more equitable than the carryback does not seem justified. The statement that,

³ October, 1947. Pp. 30. *Hearings*, pp. 3783-3797. This study was prepared jointly by the Treasury Department and the staff of the Joint Committee on Internal Revenue Taxation. Many of the other studies were discussed with the staff of the Joint Committee but are "not to be considered as necessarily representing the views of the staff of the Joint Committee . . ."

"Most dollars spent by a business enterprise are for the purpose of bringing in future, not past, income," (p. 4) ignores the stated purpose of the loss carryover, to equalize the taxation of stable and fluctuating incomes. It is recognized that while the carryforward would be more effective in stimulating new businesses, "carrybacks might stimulate business expenditures during a period of losses somewhat more than carryforwards." (p. 6) The former effect, however, is apparently considered more important than the latter, because the study concludes that the carryforward is preferable on economic grounds. As for administrative considerations, the study very much favors the carryforward because it does not involve opening tax returns of previous years as does the carryback. This reasoning does not seem at all logical, however, in view of the fact that the government does not get around to auditing tax returns for several years and has no hesitancy whatsoever in demanding that taxpayers open their books for three years back. Business men who are put to considerable bother and expense by internal revenue agents would certainly not be impressed by any such reasoning and might go so far as to suggest that the best way to solve the administrative problems would be to abolish the tax altogether.

Small Business

*Taxation of Small Business*⁴ finds that most discussions of the subject start from one of two points of view: "that the tax system should be deliberately biased in favor of small business" or "that special measures are necessary

⁴ October, 1947. Pp. ix + 87. *Hearings*, pp. 3739-3782.

to assure [small business] substantially equal tax treatment." (p.ii) The study considers measures to benefit small business by modifying the base or rate of the corporate income tax, by equalizing taxes on incorporated and unincorporated business, and by exempting small businesses or investors in them from taxation. After considering these proposals it is concluded: "The most important condition to prosperity of both small and large business is a high and stable level of national economic activity. Therefore, although it may be desirable to give consideration to measures designed especially for small business, the most important contribution the tax system can make to the healthy growth of small business as well as of large business, is through general tax revisions that improve the equity of the system and minimize any adverse effects on investment and consumer demand. Reliance on general tax measures is likely to involve fewer economic, equity, and administrative problems than does use of special small business measures." (p. 3)

In discussing the graduation of corporate income tax rates, too much emphasis is given to the dampening effect of a notch provision which is necessitated by a limited graduated system. The profitability of business undertakings often cannot be foreseen readily. The corporate income tax may have great influence upon the undertaking of business ventures inasmuch as in many cases the beginning rate of 21 per cent may make undertakings appear unprofitable. Although profits may be very uncertain at first, once an operation is undertaken the corporate manager will strive for maximum earnings.

It is beside the point to say that companies will be discouraged from earning more than \$25,000 unless they can earn more than \$50,000, because in many cases the corporation manager cannot predict the results of his decision or forecast income within any such range. If it were known before a business were started that income would generally fall between \$25,000 and \$50,000, the 53 per cent notch rate might have a discouraging effect on some business men who might choose businesses that would bring in either less than \$25,000 or more than \$50,000. But it is impossible to forecast business income with such accuracy. Furthermore, income of corporations of this approximate size is very fluctuating. Sometimes a slight change in product has a surprising effect on earnings. Then again large expenditures for promotion may prove disappointing in their results or the purchase of new equipment may turn out to have just missed the market for the product involved. If a business which has been earning \$75,000 for a number of years has a bad year and earns only \$35,000, the manager is not going to decide that because the last \$10,000 of corporate income was taxed at 53 per cent he will curtail operations the following year, so that the corporate income will be only \$25,000. Nor in the case of a corporation which has ordinarily been earning \$20,000 but which has a very successful year and earns \$35,000 will he decide that the extra income is not worthwhile because it is taxed at 53 per cent. Corporate income is by no means all the result of planning. It is very dependent on sales, markets, and the cost of raw materials and labor.

Given a certain combination of productive factors with which to work, the corporate manager will strive for maximum earnings.

Exemption of a limited amount of net income from section 102 of the Internal Revenue Code, which imposes a surtax on corporations improperly accumulating surplus, is not favored by this study because it "would give rise to important equity and administrative problems." (p. 2) It is believed rather that "The remedy for any existing deterrents to legitimate accumulations appears to be further dissemination of information as to the purposes and administration of section 102." (p. iv) There is supposed to be a sharp line drawn by the Bureau of Internal Revenue between "accumulation of profits for reasonable business purposes and improper accumulation for purposes of tax avoidance." (p. 15) Some realization of the fact that business may not be aware that this is the case appears in the statement: "Despite the lack of a substantial foundation for such an attitude, it may be true that officers and directors of some small corporations are so apprehensive about section 102 that they are failing to retain earnings for legitimate business purposes." (p. 16) As long ago as 1934 the Treasury stated: "No operating corporation accumulating surpluses and using the same in the business in which it is engaged should be apprehensive." (p. 15) On the other hand, "Collectors of Internal Revenue and other officers and employees of the Bureau of Internal Revenue have been instructed to give close attention to the returns of . . . corporations which have not distributed at least 70 per cent of their earnings." (p. 15) These instructions have been

closely followed by internal revenue agents, eager to demonstrate their efficiency and perhaps to help justify their existence. There is considerable confusion in the minds of many business men as to whether the 70 per cent rule is part of the law or the regulations, and in any case, business men usually rely on their tax accountants for advice on all such matters. Tax accountants for their part, solicitous of their own reputations and not wanting to lose clients through failure to impress them with the pitfalls of the tax laws, generally err on the side of safety and strongly urge payment of at least 70 per cent of earnings. Since small corporations generally retain more of their profits than large corporations, the matter is particularly important for them. If the Treasury is concerned about the situation, it can do much to correct it.

Farmers' Cooperatives

*The Taxation of Farmers' Cooperative Associations*⁵ considers "one aspect of the broader problem of the taxation of various forms of business enterprises." More than half of farmers' cooperative associations are exempt from the income tax. Exempt associations are those which "return all net proceeds to patrons without discrimination between members and non-members." (p. iii) Since the income earned by these associations for the most part is paid out in patronage dividends and affects the individual tax liabilities of the patrons and members who receive it, "the tax treatment of exempt farm cooperatives is . . . in principle similar to the treatment of partnerships and

⁵ October, 1947. Pp. vii + 60. *Hearings*, pp. 3127-3161.

proprietorships, which pay no tax as such but whose participants are taxed on the income they derive from the business." (p. i) The treatment of farmers' cooperative associations is more favorable in one respect, i.e., in allowing the establishment of certain reserves which are taxable neither to the association nor its members. Taxable associations are taxed on dividends on capital stock and on reserves, but not on patronage dividends. "The question at issue is, therefore, not whether the profits of cooperatives should be taxed or not taxed, but whether the income earned by these organizations should be more heavily taxed before it is distributed to the individual owners

of the business." (p. 2) Discontinuing exemptions would not be an easy matter, however, as indicated in the discussion of various possible methods of taxation and the difficulties inherent therein. More attention might have been given to the possibility of taxing the reserves of these exempt associations even though taxation of their dividends might not be feasible. A comparison of the equity, the economic effects, and the administrative considerations of such a plan and the credit-for-dividends-paid plan for corporations would have been very interesting.*

* The second installment of this article will appear in the September, 1948, issue.

DEPRECIATION IN THE TAX LAWS AND PRACTICE OF THE UNITED STATES, AUSTRALIA, CANADA, GREAT BRITAIN, NEW ZEALAND, AND SOUTH AFRICA

RAYMOND E. MANNING *

BUSINESSMEN are not very happy over the way the allowance for depreciation as a deduction for income tax purposes is handled in the United States. Indeed, they say that it is the one allowable deduction which "occasions more controversy between taxpayers and the Bureau of Internal Revenue than any other."¹ Financial executives participating in a questionnaire voted it as their opinion that controversies over depreciation provide, with one exception, "the most troublesome aspect of Federal tax administration."²

Many of the depreciation problems in the United States stem from the fact that the taxpayer has the burden of justifying the amount of depreciation claimed. Business generally desires to write off depreciation much faster than the Bureau of Internal Revenue will allow. And there is disagreement as to what is a capital expenditure to be written off over a period of years and what may be taken currently in the year of expenditure. Prior to 1934, the general practice of the administration was to allow whatever the taxpayer claimed, unless the claim was unreasonable and the burden was on the Bureau to prove it unreasonable. Business

yearns for a return to those halcyon days.

The law itself is not too difficult. It permits a reasonable allowance for exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in a trade or business, or property held for the production of income.

The purpose of this paper is to compare the law and practice in the principal English-speaking countries (Australia, Canada, Great Britain, New Zealand, and South Africa) to see if there is anything to be learned in the way of precedent, or to determine whether the law and practice in the United States is not already "ahead" of that abroad.

The conclusion is that in some respects, the United States law and practice are the more liberal, but there are some individual features of the foreign law and practice that American business would doubtless very much like to have incorporated in United States law. On the choice of methods of taking depreciation, more freedom is allowed in the United States than elsewhere. The American businessman may have the burden of upsetting a Bureau determination on how much depreciation he can take, but he at least has the chance to prove the Bureau to be wrong. In some cases abroad, he does not even have that chance.

Included among those features of foreign law which treat business more favorably are the following: more lib-

* The author is a member of the staff of the Legislative Reference Service, Library of Congress.

¹ Paul W. Smith, in House Ways and Means Committee Hearings, *Revenue Revisions, 1947-48*, p. 1521.

² George Terborgh, *ibid.*, p. 3304.

eral carry-over of depreciation in loss years, accelerated depreciation, an initial deduction of a substantial part of a capital expenditure in the year of expenditure, full deduction or accelerated writing off of scientific research expenditures, and current deduction for soil conservation and certain other expenditures by farmers.

Outline

The law and practice of each of the countries, including the United States, are presented below, first in a brief running text and then in detailed outline form. In the outline presentation, material is classified under various headings as follows:

- I. Definition and scope
- II. Historical note
- III. Purposes for which property must be used
 - A. General rule
 - B. Rule when property used only in part for such purposes
- IV. Depreciable property
 - A. Real property
 - B. Tangible personal property
 - C. Intangible property
- V. Nondepreciable property
 - A. Real property
 - B. Tangible personal property
 - C. Intangible property
- VI. Computation of depreciation
 - A. Value upon which computation made
 - B. Methods in general
 - C. Straight line method
 - D. Declining balance method
 - E. Replacement cost method
 - F. Other methods
- VII. Rate of depreciation
 - A. Determination of rate
 - B. Administrative discretion (including review)
- VIII. Special cases
 - A. 100 per cent deduction in year in which expenditure made

- B. Special initial deduction less than 100 per cent
- C. Special treatment of expenditures for scientific research
- D. Special treatment of war facilities

IX. Tax benefit rule

- X. Sale or other disposition of depreciated property

The preliminary brief discussion will follow substantially this outline.

Definition, Theory, and History

The law with respect to depreciation is quite brief in most countries. Great Britain, however, is an outstanding exception owing to enactment in 1945 of an elaborate statute spelling out the provisions in great detail.

Wear, tear, and obsolescence are the recognized elements in depreciation in the laws of Great Britain (see I-4),³ New Zealand (see I-5), and South Africa (see I-6), as well as the United States (see I-1). But this is technically not the case in Australia (see I-2) and Canada (see I-3). In neither of these countries is the law related in specific terms to any standard. The Australian law simply requires an estimate of the life of the asset to be made by the Commissioner, who will fix an annual per centum deduction accordingly. No definitions appear in Canada, but the law specifically forbids an allowance for obsolescence.⁴

Though depreciation is allowed by the laws of all the countries under review, there is (or was) sometimes a

³ References such as this are to the numbering of items in the outline beginning on p. 162.

⁴ There is of course considerable protest against this. The Canadian Bar Association, for example, has recommended that an allowance be made. *Proceedings of the Special Committee of the Senate of Canada* (1946), pp. 156-157.

problem of rationalizing the allowance because of the nonrecognition of capital gains and capital losses as elements to be considered in arriving at taxable income. This flows from the theory that depreciation is itself a capital loss.⁵ Thus, in several of the countries, depreciation is not taken as a deduction in computing taxable income. Rather it is an allowance to be taken after profit has been computed.⁶ For many years,

Great Britain had an income tax but made no allowance at all for depreciation, while the New Zealand law was in operation about a decade before depreciation was recognized. In Great Britain the disallowance was based at least partly on the fact (or theory) that the income tax was a temporary law continued from year to year and in the "expectation" that it would sometime come to an end.⁷

The Problem

The problem of "timing" is essentially the one faced by American business. As already pointed out above, business would like more freedom in determining in which years it should take depreciation and how much.⁸

⁵ Americans will find the procedure in Great Britain, for example, a strange one. There a tax is levied for "X" year based on the profit of the preceding year, but the allowance for depreciation is based not on usage during the preceding year, but on usage during "X" year.

⁵ J. P. Hannan, *Principles of Income Taxation* (Sydney: Law Book Co. of Australasia, 1946), p. 281.

Perhaps no really useful purpose would be accomplished by an inquiry into the theory of depreciation, but a few thoughts may be of interest.

The U. S. Supreme Court has said: "Before coming to the question of profit at all the company is entitled to earn a sufficient sum annually to provide not only for current repairs, but for making good the depreciation and replacing the parts of the property when they come to the end of their life. The company is not bound to see its property gradually waste, without making provisions out of earnings for its replacement. It is entitled to see that from earnings the value of the property is kept unimpaired, so that, at the end of any given term of years, the original investment remains as it was at the beginning." *May v. Knoxville Water Co.*, 212 U. S. 1.

A representative of the Canadian Bar Association had this to say: "Two contradictory theories must be considered. Under one theory, depreciation is given to replace the amount expended in purchasing a capital asset which is used to earn the profits. Under the other theory, which is supported by the English Courts, a capital asset used in trade diminishes in value every year and this reduction in value is something of the nature of rent, and the actual amount by which the value of the asset is reduced is a proper charge against profits." *Proceedings of the Special Committee of the Senate of Canada*, (1946), p. 120.

A Canadian field auditor of the Department of National Revenue explained that, "The depreciation allowance is intended to cover the estimated reduction of utility value occurring in spite of ordinary current repairs. . . the function of the depreciation allowance is to return capital over the period of life of the asset. . . ." Rowland Swift, "Depreciation Allowance under the Income War Tax Act," *Canadian Chartered Accountant*, XXXII (May, 1938), 386, 388.

⁷ Even today in Britain and many of its dominions, etc., the income tax in theory is not permanent. Each year an act of Parliament is necessary to set the rates for the ensuing year. Of the British practice, it is said: "Income tax is not in theory a permanent tax, but is a yearly tax only, imposed by the Finance Act of the year. . . . Each Finance Act imposes the tax for the year to the 5th April following, when the tax would automatically cease were it not for section 210 (1918), and the Provisional Collection of Taxes Act, 1913. The latter Act continues the existing law for a month from 5th April, to enable the budget resolutions to be passed." Ernest E. Spicer and Ernest C. Pegler, *Income Tax* (17th ed.; London: H. F. L. Ltd., 1947), p. 2.

⁸ A proposal of the Special Tax Study Committee to the Committee on Ways and Means recommended that ". . . in the case of assets with a life of more than 5 years, a deduction shall be allowed for the depreciation claimed by the taxpayer on his return, in accordance with the method of computing depreciation and the rate used in his books of account." *Reports. . .* (November 4, 1947), p. 27.

Numerous other individuals and groups have made recommendations for liberalization of allowances, and, in general, letting the taxpayer make his own decisions.

Usually, the desire is to claim the entire capital expenditure over a shorter period—even all in the first year. Though it is argued that depreciation and obsolescence are not subject to scientific measurement, it is insisted further that even this is not the essential problem. As business sees it, the important thing is the sufficiently early recovery of invested capital to encourage additional capital investment.⁹ Business believes further that the deduction should each year result in a reduction of tax, and if it does not so result (as when a loss occurs) the deduction should be postponed until it will result in a reduction of tax. Otherwise, the taxpayer never completely recovers his capital.

Depreciable Property

To be eligible for a depreciation allowance, the rule is general that the property must be used in a trade or business or in the production of income (see III-A). This of course excludes one's personal residence, his clothing, automobile, etc. (see V). There are, however, times when such assets (as well as others) may be used for both personal and business purposes, in which

case there is often some method of apportionment provided (see III-B).

Property on which depreciation may be taken is generally more extensive in the United States than in other countries (see IV; V). Americans will be struck especially by the fact that buildings are not considered a proper subject of depreciation in Australia (see V-A2) and South Africa (see V-A6). The British law is confined to industrial buildings and structures (see IV-A4), thus automatically excluding hotels, office buildings, retail stores, etc. The answer of a Royal Commission in Australia to pleas for a depreciation allowance on buildings was stated as late as 1934 in the following language:

We received many requests that depreciation on buildings should be allowed in all cases. There are many buildings, however, which with repairs and maintenance, all of which are of course allowed as deductions, will last for hundreds of years. There is the further consideration that many substantial buildings in good localities have not depreciated in value—on the contrary the property as a whole has appreciated owing to an increase in values of the site on which the buildings stand.¹⁰

Machinery, implements, etc., used in the production of income are generally considered proper subjects of depreciation (see IV-B). Rules vary with respect to animals (see IV-B).

So far as intangibles are concerned, the United States is much more liberal than most of the countries (see IV-C1). Here patents, copyrights, certain licenses, franchises, etc. may be written off proportionately each year. A proportionate write-off is allowed annually

A commentator in Britain points up a similar thinking in that country but concludes: "It is too much to hope, perhaps, that Parliament will ever enact that depreciation provisions actually made in the accounts of individual taxpayers shall be accepted as the basis of taxation allowances." W. H. Higginbotham, "Plant Registers—with Special Reference to the Income Tax Act, 1945," *Accountancy* (London), January 1947, no. 641, p. 9.

⁹ One critic bluntly states that we should "jettison the useful life concept" as a basis for computing depreciation, "and recognize the depreciation allowance for what it really is, a 'capital recovery allowance.'" Frederick S. Blackall, Jr., House Ways and Means Committee Hearings, *Revenue Revisions*, 1947-48, p. 1349.

¹⁰ Royal Commission on Taxation, *Third Report* (Canberra: Commonwealth Government Printer, 1934), p. 101.

for patents in Canada (see IV-C3), Great Britain (see IV-C4), and New Zealand (see IV-C5), and this is about as far as most of these countries go. No deductions at all are allowed for intangibles in Australia (see V-C2) and South Africa (see V-C6).

Methods and Rate

Cost to the taxpayer is the usual value upon which depreciation is based (see VI-A), with consideration being often given to expected salvage value. Special provisions departing from the general rule are found in Canada (see VI-A3) and Great Britain (see VI-C4; VI-D4). Expenditures for replacement are allowed as a deduction in several cases, such as hotel glassware, linen, and certain other items, in lieu of depreciation (see VI-E).

The use of any method of taking depreciation in trade practice is permitted by United States law (see VI-B). In most of the other countries, there is no such "liberal" provision (see VI-B), and taxpayers are confined to one or two methods, usually (or at least principally) the declining balance method (see VI-D). If business in such other countries only had the freedom permitted by the United States system, all would be well—according to much of the literature.

Although there is this wide freedom of choice in the United States, the straight line method of equal annual deductions is most frequently used (see VI-C). The declining balance method of a given percentage being taken each year from the balance remaining after deducting the depreciation of the preceding year, is most generally used in other countries (see VI-D). An interesting point is that

the declining balance method in recent years has been put forward in the United States as a possible answer to the contention that greater sums should be deducted in the early years.¹¹ Yet in Great Britain and South Africa, both of which are especially committed to this method, there is strong disposition to criticize it and argue for straight line depreciation.¹²

The rate of depreciation usually depends on a variety of circumstances, such as estimated life, particular con-

¹¹ No great enthusiasm has been expressed but there has been more than a casual mention. Roy Blough, "The Case Against Tax Reduction," *Taxes* XXIII (August, 1945), 696; Paul D. Seghers, "Accelerated Depreciation and the Treasury's New Declining Balance Method of Computation," *Journal of Accountancy* LXXXIII (February, 1947), 113-116; Gerhard J. Mayer, "Declining Balance Depreciation," *Taxes*, XXV (February, 1947), 162-171; William L. Ashbaugh, "Declining Balance Depreciation Can Work under T. D. 4422 Plus I. T. 3818," *Journal of Accountancy*, LXXXIII (May, 1947), 394-401.

¹² Some of the "Working Parties" set up by Sir Stafford Cripps have been quite critical of the declining balance method. They point out that under the British method, "... the cost of the plant is never entirely written off. . . . The American system, it is averred, gives absolute certainty regarding the period during which the cost of the plant will be written off." See "Recommendations of the Working Parties on Taxation," *The Accountant's Magazine* (Edinburgh), LI (March, and December, 1947), 128-129, 499-500. See also *The Accountant* (London), CXVII (1947), 52, 161.

The British preference for the declining balance method seems to stem not so much from any theoretical superiority as from the fact that machinery records are inadequate to permit use of the straight line method. As one writer said: "The Inland Revenue's dislike of the straight line method . . . is founded not so much on their reluctance to change their ways, as on the general failing of industry to maintain plant registers." R. W. Moon, "Depreciation and Industrial Efficiency," *Accountant* (London), CXXVII (July 26, 1947), 51.

For South African opinion, see Social and Economic Planning Council, *Taxation and Fiscal Policy* (Pretoria: Government Printer, 1945), Rept. No. 7, p. 28.

ditions of use, etc. (see VII-A). Most of the countries (but not Canada) have published official average over-all rates which may be varied depending upon conditions. In Australia, however, adherence to the published schedule is said to be quite rigid (see VII-A2). And in Britain, a fixed rate has been set so that industrial buildings will be written off in exactly forty-five or fifty years, without reference to any special circumstances (see VII-A4). Rates on plant and machinery in Great Britain have usually been fixed through agreement between industry representatives and the Board of Inland Revenue; in recent years, Parliament has increased the rates so fixed by a given percentage (see VII-A4). Canada limits the amount that may be claimed for tax purposes in any one year to amounts actually set out on the books of the taxpayer (see VII-A3a). This rule gives rise to a conflict of interest especially when applied to the recently given temporary authority to double depreciation rates for certain new investments (see VII-A3b).¹³

The degree of discretion residing in administrative officers is such that businessmen in most countries take exception to it. Discretion is perhaps widest in Canada, where the law denies depreciation except as the Minister in his dis-

¹³ "It is becoming apparent that this rule may have some totally unexpected and undesirable consequences. The offering to taxpayers of incentives by way of special depreciation allowances creates problems of an accounting nature which are of considerable difficulty and the shackling of the depreciation charge in the accounts to the actual amount claimable for tax purposes permits no freedom of action whatsoever in determining the most appropriate method of stating the periodic income of the taxpayer." J. Grant Glassco, "The Treatment of Depreciation under the Income Tax Bill," *Canadian Chartered Accountant*, LI (December, 1947), 328-329.

cretion may allow it (see VII-B3). Similarly in New Zealand, the Commissioner apparently is not bound to make any allowance, and such allowance as he does make cannot be questioned (see VII-B5). The Commissioner's discretion in South Africa must be based upon more than a "guess" (see VII-B6).

No special appeal or review procedure exists in most of the countries (see VII-B), although in Australia (see VII-B2) dissatisfied taxpayers may appeal to a Board of Review whose decision (unless the members have "misdirected themselves") is final, and in Great Britain (see VII-B4) a Board of Referees hears appeals by or on behalf of any considerable number of persons engaged in any class or trade or business.

Special Treatment in Certain Cases

A number of exceptions to the general rules have been developed in recent years, especially during and since the war, in most of the countries (see VIII). Under these provisions, the full capital expenditure may be taken in the year in which made (see VIII-A), or a special initial deduction may be taken in the first year (see VIII-B). Other provisions give special treatment to expenditures for scientific research (see VIII-C). War facilities received preferred treatment in most of the countries (see VIII-D). It is only in the latter category that the United States qualifies in an important way for discussion.

Examples of capital expenditures which may be taken in full in the year in which made include intangible drilling and development costs of oil and gas wells in the United States (see

VIII-A1), certain prospecting and exploratory work for minerals in Australia (see VIII-A2) and Canada (VIII-A3b), expenditures by farmers for preventing soil erosion, eradication of pests, as well as certain other expenditures, in Australia (see VIII-A2d) and South Africa (see VIII-A6). A number of bills have been introduced in the Congress to allow comparable benefits to United States farmers.¹⁴

Australia (see VIII-B2), Britain (see VIII-B4), New Zealand (see VIII-B5), and South Africa (see VIII-B6) have all adopted legislation to permit a large initial deduction for certain capital expenditures in the year in which made.¹⁵ Recommendations for similar legislation have been made in the United States.¹⁶ Only in Britain (see VIII-B4) are the provisions in the form of permanent legislation. In other countries they are designed as temporary stimulants to postwar recovery and expansion. The allowance is 20 per cent in Australia, 10 per cent to 20 per cent in Britain, 30 per cent over five years in New Zealand, and 15 per cent in South

Africa. In addition, a provision in Canada allows up to double rates on certain new postwar investments (see VII-A3b).

All, including Canada, give special treatment to capital expenditures for scientific research, allowing either the entire amount, or a substantial part thereof, to be taken in the year in which made (see VIII-C). Proposals along this line have also been made in the United States.¹⁷ Perhaps of particular interest is the statement by the Director of the Office of Scientific Research and Development:

One of the most important factors affecting the amount of industrial research is the income-tax law. Government action in respect to this subject will affect the rate of technical progress in industry. Uncertainties as to the attitude of the Bureau of Internal Revenue regarding the deduction of research and development expenses are a deterrent to research expenditure. These uncertainties arise from lack of clarity of the tax law as to the proper treatment of such costs.

The Internal Revenue Code should be amended to remove present uncertainties in regard to the deductibility of research and development expenditures as current charges against net income.¹⁸

Special consideration for war facilities is perhaps now a subject of past interest, but a brief note of it is made here. The sixty-month amortization provision in the United States is well-known (see VIII-D1), and bills have been introduced in Congress to make permanent

¹⁴ 80th Congress. S. 2036, H.R. 4185, 4556, 6312, 6315, 6321, 6340, 6370, 6462, 6491, 6526, 6712.

¹⁵ This provision of course does accelerate the rate of write-off but does not reduce the length of time over which the depreciation takes place, especially when the declining balance method of taking depreciation is used.

¹⁶ See for example the recommendation of the U.S. Chamber of Commerce which urged an allowance of 25 per cent of current capital expenditures as a current expense, deductible either in full in the year of expenditure or over a five-year period. In support of this position, it was argued: "Present costs of construction and equipment are very high. Many taxpayers are fearful that if they make expenditures at present price levels they will find in a few years that they have equipment in their accounts at far above replacement costs. If there is a general withholding of needed expenditures until prices come down this may be a very serious condition. . . ." House Ways and Means Committee Hearings, *Revenue Revisions, 1947-48*, pp. 1581, 1585.

¹⁷ *Reports of the Special Tax Study Committee to the Committee on Ways and Means* (November 4, 1947), p. 65; U.S. Chamber of Commerce, *House Ways and Means Committee Hearings, Revenue Revisions, 1947-48*, p. 1583; Tax Executives Institute, *ibid*, p. 1819.

¹⁸ *Science, The Endless Frontier* (A Report to the President by Vannevar Bush [Washington: Government Printing Office, 1945]), p. 16.

a similar arrangement.¹⁹ In Australia (see VIII-D2a) and Britain (see VIII-D4) there was a provision for recomputing taxes for the war years where, after the war, the value of property used in connection with the war was less than it otherwise would have been. A somewhat similar provision was in force in New Zealand (see VIII-D5). Canada set up a special board to govern extra allowances for plant and equipment built or acquired to work on war contracts (see VIII-D3a). No record of special consideration was found for South Africa.

Tax Benefit Rule

A major source of complaint in the United States has been that if taxpayers are entitled to take depreciation in computing taxable income, they must take the deduction even though they suffer a loss in the particular year and thus get no tax benefit from it. The argument has been that taking the deduction in a year in which there is no income (even without the deduction) deprives them of ever getting back their entire original capital investment. Australia (see IX-2a) and South Africa (see IX-6a) seem to follow similar rules, although Australia (see IX-2a) in 1947 adopted special legislation under which the mining industry could carry forward any depreciation which did not result in tax reduction. In Canada, only 50 per cent of the regular depreciation need be deducted in a year of loss (see IX-3a). Britain is perhaps the most liberal of all in permitting unused allowances to be carried forward indefinitely (see IX-4a). In New Zealand,

and, the taxpayer is not required to report more depreciation for tax purposes than he sets up on his books (see IX-5a).

A mitigating factor in all the countries is that losses in general may be carried forward or backward for a period of years to reduce the gains of such years (see IX-1b; IX-2b; IX-3b; IX-4b; IX-5b; IX-6b). The two-year carry-forward and two-year carry-back of losses in the United States are deemed inadequate by business, because of certain technical restrictions and shortness of the carry-over period.²⁰

Sale or Other Disposition of Depreciated Property

The sale or other disposition of depreciated property creates problems and situations that are somewhat different in other countries from those in the United States. The reason is that capital gains and losses are generally not recognized in the countries under consideration.²¹ In the United States, if property is sold for more than its depreciated value it is treated as a capital gain (and subject to limitations on full taxation), but if sold for less, the balance is considered an ordinary loss and deductible in full (See X-2). In Can-

²⁰ See, for example, statements before the House Ways and Means Committee, *Revenue Revisions, 1947-48*, pp. 1404, 1406, 1424, 1472, 1692, 1693, 1811, 1812, 1862, 1864.

²¹ Depreciation itself in some of the countries is deemed a kind of capital loss and not an expense to be deducted in computing income. It is an allowance made after income has been computed. It is a concession. "... the wastage or depreciation of a capital asset is unquestionably a capital loss, and for income tax purposes a loss of capital cannot be recognized as a real cost of earning income." J. P. Hannan, *Principles of Income Taxation* (Sydney: Law Book Co. of Australasia, 1946), p. 281.

¹⁹ 80th Congress. S. 1827, H. R. 4637. Henry J. Kaiser has made the same recommendation. *New York Times*, September 15, 1947, p. 28.

ada (with minor exceptions) no gain or loss is recognized on the sale of a depreciated asset for more or less than its depreciated value (see X-3a). In Australia (see X-2), Great Britain (see X-4), and South Africa (see X-6) where depreciated property is sold for more than its depreciated value, the excess—but not more than the sum of all depreciation previously taken—is treated as income. When sold for less than its depreciated value in Australia, Great

Britain, and South Africa, the balance is allowed as a loss. In New Zealand, where property is sold for more than the depreciated value, the allowances of prior years are reduced proportionately and additional tax assessed for such years; if sold for less than the depreciated value, a deduction will be allowed in the year of sale, except in the case of buildings, for which no additional deduction will be permitted (see X-5).

OUTLINE ANALYSIS OF DEPRECIATION LAW AND PRACTICE IN UNITED STATES,
AUSTRALIA, CANADA, GREAT BRITAIN, NEW ZEALAND, AND SOUTH AFRICA *

I. DEFINITION AND SCOPE

I-1. *United States*.—Depreciation is the gradual diminution in the useful value of tangible property resulting from wear and tear and normal obsolescence. The term is also applied generally to amortization of the value of intangible assets such as copyrights, patents, and private contracts such as leaseholds with a legal and effective life of definite duration.

I-2. *Australia*.—Depreciation is not directly related by the statute to wear, tear, obsolescence, or any other factor. The law requires that the Commissioner, in the first calculation of depreciation, estimate the effective life of the unit, assuming that it is maintained in reasonably good order and condition, and fix the annual depreciation per centum accordingly. (I.T.A.A., sec. 54-55)

I-3. *Canada*.—Depreciation is not defined by statute, and there has never been any clear-cut statement by the income tax administration as to what the allowance for depreciation is supposed to cover. (*Canadian Chartered Accountant*, LI [December, 1947], 327) The law specifically forbids a deduction for obsolescence (I.W.T.A. sec. 6 [1] [b]). However, obsolescence is said to play a certain part in calculating the asset value against which depreciation is charged. (Stikeman, *Senate Special Committee Proceedings*, 1946, p. 23) It should also be noted that when depreciable assets have become obsolete, they may continue to be depreciated so long as they are not scrapped. (C.C.H., para. 10-688a)

I-4. *Great Britain*.—A system of "allowances" established pursuant to the Income Tax Act of 1945 allows (a) a given percentage of the cost to be taken in the first year, (b) a given percentage to

be taken annually (including the first year), and (c) a balancing allowance to be taken upon disposition of the assets for less than the depreciated value. Wear, tear, and obsolescence are thus recognized and included within permitted deductions. (I.T.A., 1945) (B.I.R. Leaflets Nos. 410, 430, 460)

I-5. *New Zealand*.—The allowance for depreciation is an allowance in respect of exhausted capital, and extends to loss by reason of wear and tear of the property or its becoming obsolete or useless. Fair wear and tear include depreciation caused by friction of the air, by exposure, and by ordinary use, but not total destruction by catastrophe. (Cunningham, pp. 410-411)

I-6. *South Africa*.—The depreciation allowance represents the diminished value of the article by reason of wear and tear. It is not a provision for replacement of the initial cost over the life of the article. Although no provision for obsolescence is included in the wear and tear allowance, a "scrapping" allowance in effect does provide for obsolescence, but only at the time of disposition of the article. (Act 31 of 1941, sec. 11 [2] [d] [j]; Act 26 of 1943, sec. 5) (Barnes, p. 99) (Social and Economic Planning Council, p. 27)

II. HISTORICAL NOTE

II-1. *United States*.—A deduction for depreciation has always been allowed in American income tax acts since the very beginning of their continuous existence. A major change in practice was adopted in 1934 when the burden of proof on reasonableness of depreciation claimed or allowed was shifted from the Bureau of Internal Revenue to the taxpayer.

II-2. *Australia*.—A deduction for depreciation has always been allowed in Commonwealth income tax acts since the Commonwealth income tax was first adopted in 1915.

* Abbreviations and short references are identified in sec. XI, below.

II-3. *Canada*.—Depreciation has always been allowed by the Dominion income tax since its first adoption in 1917. By legislation in 1940 depreciation was denied except as allowed in the discretion of the Minister of National Revenue. Before this change, depreciation was allowed (the allowance being stated positively rather than negatively as under the present statute) in the Minister's discretion. The change was made to overcome some of the effects of the decision in *Pioneer Laundry and Dry Cleaners Ltd. v. Minister of National Revenue*, 1938 Ex. C.R. 18, 1939 S.C.R. 1, 1939 4 D.L.R. 481. Important changes are now being considered as part of the pending general revision of the income tax.

II-4. *Great Britain*.—Depreciation allowances—or the equivalent—have not always been a feature of English income tax law. Prior to 1878, no deduction was allowed. In that year an allowance was made for wear and tear of machinery and plant. No deduction for depreciation of buildings was made until 1918. Several important changes were made in the years after 1918, but of much greater importance was the very extensive revision of 1945. This elaborate and complicated code of regulations practically supersedes the comparatively few and simple provisions which served previously. The new provisions are designed to provide a postwar relief and assistance to industry in a program of rehabilitation.

II-5. *New Zealand*.—Depreciation was not allowed under the first income tax (1890). It was not until 1900 that provision was first made. This concession did not extend to buildings, and it was not until 1917 that depreciation was first allowed for buildings. This continued until 1923, when in lieu of depreciation of buildings an allowance of 5 per cent was made on the capital value of land used in producing taxable income. Beginning with 1930, the 5 per cent allowance was discontinued, and a depreciation allowance for buildings was restored. (Cunningham, p. 687)

II-6. *South Africa*.—A deduction for depreciation has always been allowed in Union income tax acts since the Union income tax was first adopted in 1914.

III. PURPOSES FOR WHICH PROPERTY MUST BE USED

III-A. GENERAL RULE

III-A1. *United States*.—The allowance is limited to property used in a trade or business, or property held for the production of income. (I.R.C., sec. 23 [1])

III-A2. *Australia*.—The allowance is limited to property used (or held in reserve for use) in the production of taxable income. (I.T.A.A., sec. 54 [1])

III-A3. *Canada*.—The allowance is limited to property used in the production of income. (C.C.H., para. 10-869)

III-A4. *Great Britain*.—The allowance is limited to property used in trade, or in professions, employments, vocations and offices, and occupation of lands. (I.T.A., 1945)

III-A5. *New Zealand*.—The allowance is limited to property used in the production of income. (L.I.T.A. sec. 80 [1] [a]) (Cunningham, pp. 410-412)

III-A6. *South Africa*.—The allowance is limited to property used for the purposes of trade. Trade includes any profession, business, employment, calling, occupation or venture, including the letting of property, and the use of or the grant of permission to use any patent, design, copyright or trade mark. (Act No. 31 of 1941, sec. 7 [h], 11 [2] [d]; Act 26 of 1943, sec. 2)

III-B. RULE WHEN PROPERTY USED ONLY IN PART FOR SUCH PURPOSES

III-B1. *United States*.—Property, though of the type ordinarily devoted to personal use—such as a residence, an automobile, etc.—may be allowed a deduction for depreciation if devoted only in part for business or the production of income. In the case of a residence, the apportionment would generally be on the basis of the number of rooms. (Bulletin "F") However, a dwelling owned and occupied by a farmer is not entitled to depreciation. (Reg. 111, sec. 29.23 [1]-10)

III-B2. *Australia*.—Where depreciable property is used only partly for producing taxable income the depreciation allowance shall be such as the Commissioner of Taxation shall determine. (I.T.A.A., sec. 61) (Gunn, p. 106)

III-B3. *Canada*.—No general rule has been found with respect to property used only in part in producing income, but the following examples are noted: Where taxpayer rents part of his home or apartment house, or a physician practices from his residence, a proportionate amount of depreciation will be allowed (McMichael, pp. 45, 50), and where a physician or commission agent uses an automobile partly in his business and partly for private purposes, depreciation will be allowed on a proportionate part, but not more than 75 per cent thereof. (McMichael, pp. 45-47)

III-B4. *Great Britain*.—Full depreciation will be allowed on industrial buildings when nine-tenths or more thereof is used for purposes in respect of which depreciation is allowed. Where more than one-tenth is used for purposes for which depreciation is not allowed, the deduction will be that fraction which is represented by the construction cost of that part for which depreciation is allowed divided by the entire construction cost. (I.T.A., 1945, sec. 8) (B.I.R. Leaflet No. 410, pp. 4-5) In the case of machinery or plant used partly for private purposes (e.g. a private automobile) a proportion of the regular depreciation will be allowed. (B.I.R. Leaflet

No. 430, p. 2) (Spicer, p. 120) In the case of a farm house, not more than one-third of the expenditure will qualify for the allowances on agricultural or forestry buildings and works; on other assets to be used partly for husbandry or forestry or partly for other purposes only a proportionate part of the expenditure will qualify. (I.T.A., 1945, sec. 33)

III-B5. *New Zealand*.—If a business or profession and the taxpayer's private residence is in the same building a proportionate deduction is allowed with respect to the part applicable to the business or profession. Similarly, in the case of automobiles, a deduction is allowed proportionate to the use for business purposes. (Handbook, pp. 44-45) In the case of a farmer's dwelling situated on the farm, depreciation is allowed on one-fourth of the cost of the dwelling. (Form JA, p. 6)

III-B6. *South Africa*.—No provision found.

IV. DEPRECIABLE PROPERTY

IV-A. REAL PROPERTY

IV-A1. *United States*.—Buildings used in a trade or business or used in the production of income, including apartments, banks, dwellings, factories, farm buildings, garages, grain elevators, hotels, loft buildings, machine shops, office buildings, stores, theaters, and warehouses. Depreciation is also allowed with respect to building equipment. (Bulletin "F") Although normally stock in trade is not a subject for depreciation, rented property held for sale but not inventoried, such as real property rented by a real estate dealer, is subject to depreciation allowance.

IV-A2. *Australia*.—Although depreciation is not allowed generally for buildings, even though used in the production of income, an allowance is made for certain structural improvements on land used for agricultural or pastoral pursuits, certain buildings used in connection with World War II (see VIII-D2b) and buildings (or parts thereof) which form an integral part of a manufacturing plant to the extent added cost was incurred for installing the machinery. (Gunn, p. 95) (I.T.O. 1217)

IV-A3. *Canada*.—Buildings, wharves and docks, theaters. (McMichael, p. 7) (C.C.H., para. 10-693) (Smith, p. 63)

IV-A4. *Great Britain*

a. Industrial buildings or structures (including walls, bridges, dams, roads, dry docks, and tunnel linings) constructed after 1896 used for the purpose of a trade carried on in a mill, factory or similar premises, a transport, dock, inland navigation, water, electricity or hydraulic power under-taking, a trade which consists of manufacturing, processing or (sometimes) storing goods or materials, working a mine, oil well, etc., or foreign plantation, or performing certain agricultural operations for farmers. (I.T.A., 1945, sec. 1-14) (B.I.R. Leaflet No. 410)

(Spicer, pp. 195-197)

b. Agricultural or forestry buildings or works (including capital expenditures for construction, reconstruction, alteration or improvement of farm houses, farm or forestry buildings, cottages, fences, drainage and sewerage works, water and electrical supply installations, walls, shelter belts of trees, and reclamation of former agricultural land). (I.T.A., 1945, sec. 33) (B.I.R. Leaflet No. 460)

c. Mining properties including expenditures in searching for deposits and construction of works which are likely to be of little or no value when the source is no longer worked. (I.T.A., 1945, sec. 27)

IV-A5. *New Zealand*.—Buildings, bridges, wharves, etc. used in the production of income (L.I.T.A. sec. 80 [1] [a]) (Cunningham, pp. 479-481)

IV-A6. *South Africa*.—(See V-A6 below showing nonallowable deductions.)

IV-B. TANGIBLE PERSONAL PROPERTY

IV-B1. *United States*.—Permanent tangible property, including machinery, trucks, office furniture and devices, and such other equipment of a relatively permanent nature used in the production and distribution of the taxpayer's goods. (Reg. 111, sec. 29.23 [1]-2) Items of a less permanent character, such as drawings and models may also be subject to depreciation unless their expected life is so short that they are properly taken as an expense in the year in which their cost is incurred. (Reg. 111, sec. 23 [1]-8) Equipment used in farm operations, breeding and dairy animals, and other capitalized farm expenditures of a limited useful life. (Mim. 6030) A professional man's library is a proper subject of depreciation. (Bulletin "F")

IV-B2. *Australia*.—Plant and other articles owned by the taxpayer which are used (or held in reserve) for the purpose of producing taxable income. Plant is defined by the law to include (a) machinery, implements, utensils, rolling stock; (b) animals used as beasts of burden (other than by primary producers, i.e. farmers, poultry raisers, dairymen, etc.); (c) fences, dams, and certain structural improvements on land used for agricultural or pastoral pursuits; and (d) plumbing fixtures and fittings whose principal use is for personal purposes of employees. (I.T.A.A., sec. 54)

IV-B3. *Canada*.—Furniture, fixtures, machinery and equipment, professional instruments and books, motor vehicles, ships, horses and wagons, etc. (McMichael, p. 74) (C.C.H., para. 10-693) (Smith, p. 63)

IV-B4. *Great Britain*.—Machinery and plant. Plant is not understood in Britain to have the same meaning often attached to it in the United States, in the sense of factory buildings, etc. The law does not define the word. According to the Oxford Dictionary, plant means the fixtures, implements, machinery, and apparatus used in carrying on any

industrial process. Court decisions have construed the word to include ships, railway locomotives, carriages, wagons and tools, as well as tramway rails. (Konstam, p. 131)

IV-B5. *New Zealand*.—Implements, utensils, or machinery used in the production of income. Included in these are (for example) vehicles, office equipment, furniture, furnishings, fittings, etc. (L.I.T.A., sec. 80 [1] [a]) (Cunningham, pp. 479-481)

IV-B6. *South Africa*

a. Machinery, implements, utensils, and articles used by the taxpayer for the purposes of his trade, including livestock in the case of a dairyman (not a farmer) or cartage contractor, furniture and fittings, farm implements, lawyer's books of law, etc. (Act 31 of 1941, sec. 11 [2] [c]) (Barnes, pp. 88, 100-101)

b. In lieu of allowances for wear and tear (and certain other purposes) an annual redemption allowance (virtually the equivalent of straight line depreciation) is granted with respect to mining operations. (Act 31 of 1941, sec. 20) (Barnes, pp. 102-104) (Silke, pp. 108-116) (Social and Economic Planning Council, pp. 32-34)

IV-C. INTANGIBLE PROPERTY

IV-C1. *United States*.—Patents, copyrights, licenses, franchises, etc., having a definitely limited useful life are proper subjects of depreciation. Contracts having a definitely limited useful life are also proper subjects of depreciation. (Reg. 111, sec. 29.23 [1]-3) (Bulletin "F")

IV-C2. *Australia*.—No provision found.

IV-C3. *Canada*.—Published sources are conflicting on the matter of depreciation of intangibles. The following quotations have been found: "You may also deduct depreciation from the income from intangible property such as patents, copyrights, licenses and franchises." (McMichael, p. 77); "Provisions for depreciation may also be deducted in respect of such tangible (sic) fixed assets as patents which are granted for a specified period but not in perpetuity. . . ." (Smith, p. 63); "The only intangible asset which is regarded by the department as capable of depreciation is a patent." (C.C.H., para. 10-6882)

IV-C4. *Great Britain*.—Patents. (I.T.A., 1945, sec. 35-43) (B.I.R. Leaflet No. 490)

IV-C5. *New Zealand*.—Patents. (L.I.T.A., 1945, sec. 12)

IV-C6. *South Africa*.—No provision found.

V. NONDEPRECIABLE PROPERTY

V-A. REAL PROPERTY

V-A1. *United States*.—Land (apart from improvements or physical development added to it), bodies of minerals which through a process of removal

suffer depletion, buildings used by the taxpayer solely for his residence. If a building is used partly for a residence and partly for business purposes (except a farmer's residence) only a proportionate deduction may be made. (Reg. 111, sec. 29.23 [1]-2, sec. 29.23 [1]-10)

V-A2. *Australia*.—Depreciation is generally not allowed for any buildings. The limited right to take a deduction for certain structural improvements on land used for agricultural or pastoral purposes does not extend to a farmer's residence. (See IV-A2 above showing allowable deductions) (Gunn, p. 96)

V-A3. *Canada*.—Land (apart from improvements or physical development added to it), buildings used solely for taxpayer's residence, bodies of minerals which through a process of removal suffer depletion. (McMichael, p. 77)

V-A4. *Great Britain*.—Dwelling houses, retail shops, showrooms, hotels and offices. (I.T.A., 1945, sec. 8 [3]) The deduction is limited to industrial buildings. (See IV-A4a)

V-A5. *New Zealand*.—(See IV-A5 above showing allowable deductions)

V-A6. *South Africa*.—No allowance shall be made for depreciation of buildings or other structures or work of a permanent nature. (Act 31 of 1941, sec. 11 [2] [d]) Included within the prohibition are store fronts, dams, fences, boreholes, railway sidings, and plantations (but see VIII-A6). (Barnes, pp. 77, 101)

V-B. TANGIBLE PERSONAL PROPERTY

V-B1. *United States*.—Stock in trade, inventories, etc., automobile or other vehicles used for pleasure, personal effects, or clothing unless used in whole or in part for business or the production of income in which case a proportionate deduction is allowed. (Reg. 111, sec. 29.23 [1]-2)

V-B2. *Australia*.—(See IV-B2 above showing allowable deductions.)

V-B3. *Canada*.—Automobiles or other vehicles used solely for pleasure or personal use, personal effects or clothing (unless properties and costumes used in taxpayer's profession, trade or business, such as theatrical enterprise). (McMichael, p. 77)

V-B4. *Great Britain*.—(See IV-B4 above showing allowable deductions.) Plant has been held not to include a stallion used for breeding purposes, the bed of a harbor, a ferro-concrete water-tower, or law books. (Konstam, p. 131)

V-B5. *New Zealand*.—(See IV-B5 above showing allowable deductions)

V-B6. *South Africa*.—(See IV-B6 above showing allowable deductions.) No deduction is allowed for stock in trade. (Barnes, p. 101)

V-C. INTANGIBLE PROPERTY

V-C1. *United States*.—Trademarks, trade names,

goodwill, formulas, newspaper subscription lists, etc., have been held nondepreciable because they have no limited useful life.

V-C2. *Australia*.—Apparently, depreciation is not allowed with respect to any intangibles.

V-C3. *Canada*.—Corporate securities, goodwill, trade marks and trade brands. (McMichael, p. 77) (See also above IV-C3 for conflict of opinion.)

V-C4. *Great Britain*.—Apparently, no deduction is allowed with respect to any intangibles, other than patents.

V-C5. *New Zealand*.—Apparently, depreciation is not allowed with respect to any intangibles, except patents.

V-C6. *South Africa*.—Share investments, patent rights, trade marks, goodwill, leases. (Barnes, pp. 77, 101)

VI. COMPUTATION OF DEPRECIATION

VI-A. VALUE UPON WHICH COMPUTATION MADE

VI-A1. *United States*.—Cost of the property, adjusted for damages, additions, and salvage value is the usual basis for computing depreciation. It is the same basis as is used for computing capital gains. (I.R.C., sec. 114 [a]) (Reg. 111, sec. 29.23 [1]-1, sec. 29.23 [1]-4)

VI-A2. *Australia*.—Depreciation is normally based on actual cost. Where taxpayer is allowed to take a current deduction for part of the cost (see VIII-B2a) that part shall be excluded in computing the allowance for depreciation. Where ownership of property has been transferred, the value upon which depreciation is computed shall not exceed the depreciated value plus the amount vendor is required to include in his income. (See X-2) (I.T.A.A., sec. 56 [3], 60, 62) (Gunn, pp. 93, 99, 104-105) (Ratcliffe, p. 480).

VI-A3. *Canada*.—Where assets were acquired before 1917, the value as already accepted by the Department is the value used for depreciation. For assets subsequently acquired, the value used shall be the cost as determined by the Department. (Ruling of July 28, 1927) However, where (with exceptions) assets have been depreciated to 80 per cent of their cost, depreciation thereafter is computed on 20 per cent (rather than 100 per cent) of the cost. Exceptions to the rule include assets with a useful life of five years or less, assets which are relatively limited in aggregate cost (say \$25,000), assets in respect of which rental income arises and each property is depreciated separately, separately distinguishable assets or class which are depreciated separately, and assets owned by a farmer. (*Canada Gazette*, February 15, 1941, p. 2938) The maximum cost of an automobile upon which a physician or commission agent may take depreciation is \$1,800. (McMichael, pp. 45, 47) Original cost, rather than cost to the owner, will control in the case of certain rental housing projects subject to double depreciation. (See VII-A4) (*Canada Gazette*,

[Part II] April 9, 1947, p. 755) (*Canadian Chartered Accountant*, LI [December, 1947], 326-327)

VI-A4. *Great Britain*.—The taxpayer's capital expenditure is the usual basis for computing depreciation, but there are exceptions. (See VI-B4; VI-C4b; VI-D4)

VI-A5. *New Zealand*.—Cost.

VI-A6. *South Africa*.—Cost.

VI-B. METHODS IN GENERAL

VI-B1. *United States*.—The value to be recovered shall be charged off over the useful life of the property, either in equal annual installments or in accordance with any recognized trade practice. When such amount has been recovered, no further deduction for depreciation will be allowed. (Reg. 111, sec. 29.23 [1]-5)

VI-B2. *Australia*.—The straight line and declining balance methods are used. In some cases, replacement cost is allowed in lieu of depreciation.

VI-B3. *Canada*.—Depreciation may be taken according to the straight line method or in accordance with any recognized trade practice such as apportionment to units of production. Whatever plan is adopted by the taxpayer, if reasonable, will be accepted. (*Canadian Chartered Accountant*, XXXII [May, 1938], 387)

VI-B4. *Great Britain*.—The straight line or declining balance methods are used. In some cases, replacement cost is allowed in lieu of depreciation. Total deductions to a taxpayer are in general limited to the difference between his capital expenditure and anything he may obtain in respect of it when sold, scrapped, or destroyed. (I.T.A., 1945) (B.I.R. Leaflets No. 410, 430)

VI-B5. *New Zealand*.—The straight line and declining balance methods are used. In some cases replacement cost is allowed in lieu of depreciation. Another "in lieu" method provides for an annual revaluation.

VI-B6. *South Africa*.—The declining balance method is used almost exclusively. In making allowances for depreciation, the Commissioner for Inland Revenue shall take into consideration the sums allowed for repairs. (Act 31 of 1941, sec. 11 [2] [d])

VI-C. STRAIGHT LINE METHOD

VI-C1. *United States*.—The straight line method of equal annual deductions is the one most frequently used. Under this method, the cost to be recovered is deducted in equal annual installments over the period of estimated life.

VI-C2. *Australia*.—The straight line (prime cost) method may be used if the taxpayer notifies the Commissioner of Taxation to that effect. (I.T.A.A., sec. 56) (Gunn, p. 92) The straight line method is used with respect to plant and development of mining property; however, the estimated life may

be revised from year to year. (I.T.A.A., sec. 122, as amended I.T.A.A., 1947, cl. 19) (Taxation Institute of Australia, Circular No. 110)

VI-C3. *Canada*.—The straight line method (fixed percentage method) is the one most frequently used. (See VI-A3 for 80 per cent rule)

VI-C4. *Great Britain*

a. The straight line method is applied to industrial buildings, ships, patents, and expenditures for scientific research. Although not in practice applied to other plant, it could be if adequate records of each item are maintained.

b. When an industrial building on which depreciation has been taken is sold, depreciation thereafter is computed on the "residue" after sale, i. e. the depreciated value plus or minus certain adjustments (balancing allowances or charges made to or against the vendor) dependent on whether the sale price is less or greater than the depreciated value. The "residue" after sale will often be the same as the sale price. Annual depreciation thereafter will be a sum found by dividing such residue by the number of remaining years over which depreciation may be taken. The total number of years over which depreciation may be taken on an industrial building shall never exceed fifty (sometimes forty-five). (I.T.A., 1945, sec. 1-14 35-43) (B.I.R. Leaflet Nos. 410, 490)

VI-C5. *New Zealand*.—The straight line (cost price) method is used principally for buildings and certain other permanent structures such as bridges, gas mains, wharves, etc. Depreciation of patents is also computed on the straight line method. In the case of buildings, etc., the amount of depreciation allowed in any year will be the lesser of that specified by the Commissioner of Taxes or the amount which, with prior allowances, reduces the asset to book value. (See IX-5a) (Cunningham, p. 478) (L.I.T.A., 1945, sec. 13)

VI-C6. *South Africa*.—Substantially the straight line method is used for mining companies where an annual redemption allowance is granted (in lieu of wear and tear allowances, allowance for new machinery, lease premiums, and scrapped plant) which is found by dividing capital expenditures (with respect to which the allowance is permitted) by the estimated life of the mine, but not more than thirty years. Capital expenditures with respect to which allowance is granted include shaft sinking and equipment, development, general administration and management prior to production or during any period of non-production. The cost of the property is not included. Further special provisions are made with respect to gold and diamond mines. (Act 31 of 1941, sec. 20) (Barnes, pp. 102-104) (Silke, pp. 108-116) (Social and Economic Planning Council, pp. 32-34)

VI-D. DECLINING BALANCE METHOD

VI-D1. *United States*.—The declining balance

method is best applied to property in which the greater proportion of the production process occurs in the early part of the useful life. The amount of depreciation is subtracted annually from the cost or other basis of the immediately preceding year, and the rate of depreciation is then applied to the resulting balance. This method is said to give satisfactory results for accounts that are being constantly replaced in substantial amounts, provided that the rate used is somewhat higher than that applicable to the straight line method.

VI-D2. *Australia*.—The declining balance (diminishing cost) method is used unless the taxpayer exercises an option to use the straight line method. (I.T.A.A., sec. 56) (Gunn, pp. 92-93)

VI-D3. *Canada*.—(See VI-B3)

VI-D4. *Great Britain*.—The declining balance (reducing balance) method is the one commonly in use for machinery and plant. The depreciation rate is applied to the original cost minus any initial allowance and annual wear and tear allowances. (Rule 6 of Cases I and II of Sched. D.) (I.T.A., 1945, sec. 16) (B.I.R. Leaflet No. 430) A taxpayer who sells machinery or plant for a price in excess of its depreciated value, and replaces it with new machinery or plant, may elect to have depreciation on the new machinery or plant computed on the cost thereof minus such excess, instead of taking depreciation on the full purchase price and including the excess for income. (I.T.A., 1945, sec. 18)

VI-D5. *New Zealand*.—The declining balance (diminishing value) method is the one most generally used for machinery and plant with a relatively short life. The depreciation rate is applied to the written down value. The amount allowed each year shall be that amount allowed by the Commissioner of Taxes or the amount written off in the year on the taxpayer's books, whichever is lesser. (See IX-5a) If in any year, taxpayer writes off more than the amount allowed by the Commissioner of Taxes, the excess will be carried forward and treated as a writing off for the following year to the extent the writing for the latter year is less than the amount computed at the Commissioner's rate. (See IX-5a) (Cunningham, pp. 477-478)

VI-D6. *South Africa*.—The declining balance (diminishing value) method is the one most generally (almost exclusively) used. The depreciation rate is applied to the original value reduced annually by the allowances taken in preceding years. (Barnes, p. 99)

VI-E. REPLACEMENT COST METHOD

VI-E1. *United States*.—No provision found.

VI-E2. *Australia*.—The cost of replacing certain articles is allowed in lieu of depreciation. The following are some examples: bedding, crockery, cutlery, etc. of hospitals, hotels, etc.; doctors' and dentists' instruments; fishing nets; loose tools. (Gunn, p. 95.)

VI-E3. *Canada*.—Replacements of stocks of china, glassware and linen by hotels may be written off in one or two years. (McMichael, p. 74) (Smith, p. 63)

VI-E4. *Great Britain*.—A "renewals basis" is in operation in some cases under which the usual deductions for depreciation are not given, but when a piece of machinery or plant is replaced, the net cost of replacement, excluding any amounts representing improvements, is allowed as a deduction. (B.I.R. Leaflet No. 430, p. 2)

VI-E5. *New Zealand*.—The cost of replacing certain articles is allowed in lieu of depreciation. The following are some examples: doctors' instruments, fencing, and printing type. (Cunningham, pp. 479-481) According to another source, replacement costs are allowed on bedding linen, crockery, technical books or journals used in a trade or profession, and replacement of trees by an orchardist. (Handbook, pp. 11-13) (See note below VI-F5 which says some of these are revalued annually.)

VI-E6. *South Africa*.—The cost of replacing certain articles is allowed in lieu of depreciation. The following are some examples: crockery, glassware, and linen as in the case of a hotel, tools as distinct from machinery in the case of a manufacturer, engineer, etc., or surgical instruments as in the case of a medical man. (Barnes, p. 101)

VI-F. OTHER METHODS

VI-F1. *United States*

a. The unit of production method is used for the most part by taxpayers owning natural resource property. Under this method, the rate of exhaustion of mineral deposits or timber measures the useful life of the physical property. But depreciation, at least to the extent that it is based on decay and normal obsolescence should be taken even when the property is idle or below normal production rates.

b. The retirement method is used most frequently by railroads. The cost of property retired each year is credited to the capital asset account and after deducting net salvage, charged to expense in lieu of annual provision for depreciation.

c. A revaluation method is used by hotels for china, glassware, linen, silver, and uniforms. The charge is made annually at inventory periods.

VI-F2. *Australia*.—No provision found.

VI-F3. *Canada*.—(See VI-B3)

VI-F4. *Great Britain*.—No provision found.

VI-F5. *New Zealand*.—An annual revaluation, in lieu of depreciation, takes place for containers (casks, cans, crates, etc.), ice cream shipping bags, loose tools, small articles requiring frequent renewal (such as bedding, linen, crockery, etc.), technical books or journals used in trade or profession, plans and specifications. (Cunningham, pp. 479-481)

VI-F6. *South Africa*.—No provision found.

VII. RATE OF DEPRECIATION

(See also VIII group below)

VII-A. DETERMINATION OF RATES

VII-A1. *United States*.—The rate of depreciation allowed depends not only on the prospective useful life of property, but also on the particular conditions of use as reflected in taxpayer's operating policy and the accounting policy followed with respect to repairs, maintenance, replacements, charges to the capital asset account and to the depreciation reserve. The Bureau has also compiled a list of estimates of useful life (including an allowance for normal obsolescence from which taxpayers may obtain the best available indication of Bureau practice and trend of official opinion. The estimates are based on averages and are set forth as a guide. Rates allowed in particular cases may vary from these averages. There have been numerous court decisions as to useful life and depreciation rates.

VII-A2. *Australia*.—Allowances depend on the estimated life of the property as fixed by the Commissioner. A schedule of rates has been published in Income Tax Order No. 1217 (as amended and supplemented) applicable for plant of average type used under normal working conditions. Increased rates are granted where the plant is used in excess of normal working time. In some instances, an overall rate has been fixed to cover groups of items of plant. The rate used is the same whether the straight line or declining balance method is used. (Gunn, p. 95) Adherence to the published schedule is said to be "rigid." (*Australian Accountant*, XVII [December, 1947], 565)

VII-A3. *Canada*

a. No statement of general principles has been found setting out guides for determining depreciation allowable. No official list of rates has been published. However, the maximum depreciation allowable shall not exceed the amount incorporated in the taxpayer's books or the amounts allowed by the Department. (*Canada Gazette*, December 2, 1933, p. 1134) Accelerated depreciation is allowed on machinery used at double or triple the normal time. When the use is at least doubled (but not tripled) normal depreciation is increased by one-half. When use is tripled, depreciation rates are doubled. (McMichael, p. 77)

b. Depreciation at not more than double rates may be allowed with respect to plant or equipment of such class or classes as may be determined by the Governor in Council, built or acquired in a period to be fixed by the Governor in Council, if the taxpayer is, in the opinion of the Minister of National Revenue, making a new investment by building or acquiring the plant or equipment. (I.W.T.A., sec. 6 [1] [n] [ii]) The period in which the depreciation may be taken has been extended from time to time and is now for the period November 10,

1944, to March 31, 1949. (*Canada Gazette* [Part II] August 27, 1947, p. 1643) Particular classes of property with different expiration dates appear from time to time, e.g. ships (*Canada Gazette* [Part II] July 9, 1947, p. 1364) and rental housing projects for veterans (*Canada Gazette* [Part II], April 9, 1947, p. 755). Specific classes of property are excluded, e.g. office buildings, apartments, buildings used for commercial or financial purposes (including stores, hotels, and tourist accommodations), automobiles, trucks, and busses, railway rolling stock, patents, goodwill, etc. (War Orders and Regulations, 1944, Part IV, p. 338) The effect of these exclusions is substantially to limit the benefits of the provision to industrial and farm property. (C.C.H., para. 10-688a) Double depreciation will not be allowed after the aggregate of allowances equals 80 per cent of the cost (War Orders and Regulations, 1944, Part IV, p. 338).

VII-A4. *Great Britain*.—A fixed rate of allowance is prescribed by statute for industrial buildings, agricultural and forestry works, and patent rights. A separate provision is made for mining. As for machinery and plant, trade fixtures and fittings, such amounts are allowed as the assessing commissioners think just and reasonable. Percentage rates have generally been agreed to by representatives of industries and the Inland Revenue; by statute the rates previously allowed under such agreements have been increased by fractions from time to time, being one-fourth at present, i.e. five-fourths of rates previously agreed to are now allowed. (I.T.A., 1945) (Spicer, pp. 158-159)

VII-A5. *New Zealand*.—The Commissioner has set out what are deemed to be reasonable average over-all rates to cover depreciation caused by fair wear and tear or obsolescence and which cannot be made good by repair. The taxpayer upon request may receive consideration of his case for higher allowances. In the case of plant and machinery the rate varies depending upon number of hours of operation and whether or not affected by acid. (Cunningham, p. 479)

VII-A6. *South Africa*.—Rates of wear and tear vary according to circumstances. Machinery running day and night would be entitled to a higher rate than that running during the daytime only. Similarly, machinery subject to chemical reaction would require special consideration. Articles owned but not used do not rank for allowance. The allowance is restricted in any year to the diminished value by reasons of wear and tear in that year. The Commissioner is not bound by the amount or rate allowed in preceding years. (Barnes, p. 100)

VII-B. ADMINISTRATIVE DISCRETION (including review)

VII-B1. *United States*.—By statute, the allowance for depreciation must be reasonable. (I.R.C., sec.

23 [1]) Where a deduction is questioned by the Commissioner of Internal Revenue, the burden is on the taxpayer to submit evidence to overcome the presumption of correctness of the Commissioner's determination. (Reg. 111, sec. 29.23 [1]-5) No special appeal or review procedure is provided.

VII-B2. *Australia*.—By statute, the Commissioner estimates the life of the property and fixes the rate of depreciation accordingly. (I.T.A.A., sec. 55) Where a taxpayer is dissatisfied with the depreciation allowed, he may have the matter referred to the Board of Review (an administrative board of appointed members). The decision of the Board is final unless it can be shown that the members of the Board have misdirected themselves, when an appeal to the High Court would be open. (Ratcliffe, pp. 475-476 [and Supp.])

VII-B3. *Canada*.—Since the law denies depreciation except in such amount as the Minister in his discretion may allow, depreciation cannot be claimed as a matter of right under the statute, but must be obtained, if at all, at the discretion of the Minister. (I.W.T.A., sec. 6 [1] [n])

VII-B4. *Great Britain*.—Rates of depreciation on plant and machinery have generally been fixed by agreement between industry representatives and the Inland Revenue. The Board of Referees (a body of professional and business men appointed by the Treasury) hears appeals by or on behalf of any considerable number of persons engaged in any class of trade or business, for the alteration of wear and tear allowances. Appeals must be referred to it by the Board of Inland Revenue. (Sched. D, Cases I and II, R. 6 [6]) (Spicer, p. 9)

VII-B5. *New Zealand*.—By statute, the Commissioner allows such depreciation as he thinks just. (L.I.T.A., sec. 80 [1] [a]) It appears that the Commissioner is not bound to make any allowance whatever, and such allowance as he does choose to make cannot be questioned. (Cunningham, pp. 413-414)

VII-B6. *South Africa*.—By statute, the Commissioner allows such depreciation as he considers to be just and reasonable. (Act 31 of 1941 sec. 11 [2] [d]) However, though the law permits the Commissioner to exercise discretion, it must be a just and reasonable discretion and not based purely on a guess. (Income Tax Case No. 569, 13 S.A.T.C. 443)

VIII. SPECIAL CASES (see also VII-A3a; VII-A3b)

VIII-A. 100 PER CENT DEDUCTION IN YEAR IN WHICH CAPITAL EXPENDITURE MADE

VIII-A1. *United States*.—At the taxpayer's option, intangible drilling and development costs of oil and gas wells may be charged to capital or to expense. (Reg. 111, sec. 29.23 [m]-16)

VIII-A2. *Australia*

a. Capital expenditures for necessary plant and development of mining property may (in lieu of

proportional deduction over the life of the mine) (see VI-C2) be taken currently. (I.T.A.A., sec. 123) (Gunn, p. 179) (Ratcliffe, pp. 805-806)

b. Capital expenditures on prospecting for or mining of petroleum may be recovered in full before income from operations becomes subject to income tax. (I.T.A.A., sec. 123A)

c. Capital expenditures on exploration or prospecting (other than for coal, gold or petroleum) on any mining tenure, may be deducted in the year in which incurred. But if the amount so deductible exceeds the profits as otherwise computed, the balance may be carried forward and apportioned (as under sec. 122 [see VI-C2]) over the remaining life of the mine. (I.T.A.A., sec. 123AA; I.T.A.A., 1947, clause 20)

d. Primary producers (i.e. farmers, poultry raisers, dairymen, etc.) may take certain capital expenditures as deductions in the year in which made, e.g. eradication of pests, destruction and removal of timber, etc., preparation of the land for agriculture, draining swamp lands, prevention of or combatting soil erosion, construction of dams or irrigation channels, sinking of bores for conserving or conveying water, contour ploughing, making fences rabbit-proof or dog-proof, etc. (I.T.A.A., sec. 75-76) (I.T.A.A., 1947, cl. 12) (Taxation Institute of Australia Circular No. 110) (Gunn, pp. 83-84)

VIII-A3. *Canada*

a. Fishing schooners on the Atlantic Coast may, at the owner's option, be depreciated 100 per cent in the first year, 100 per cent in any one of the succeeding four years, or 100 per cent spread over four years. (War Orders and Regulations, 1944, vol. II, p. 531)

b. Allowances have been made in recent years (on a year to year basis) for expenditures on exploration for oil, gas, and other minerals. (Statutes, 1947, c. 63, sec. 16)

VIII-A4. *Great Britain*.—No provision found.

VIII-A5. *New Zealand*.—No provision found.

VIII-A6. *South Africa*.—The whole amount of expenditures on dipping tanks, dams, water-furrows, bore holes, pumping plants, fences, the eradication of noxious plants, the prevention of soil erosion, the erection of buildings used in connection with farming operations other than those used for domestic purposes, and the establishment of orchards and vineyards, is allowed as a deduction from taxable income in the year in which it is incurred. But such deduction shall not exceed 30 per cent of the gross income from farming during the year in which the expenditure is incurred. (Act No. 31 of 1941, sec. 14 [12]; Act 47 of 1944)

VIII-B. SPECIAL INITIAL DEDUCTION LESS THAN 100 PER CENT

VIII-B1. *United States*.—No provision found.

VIII-B2. *Australia*

a. A special initial depreciation allowance is granted with respect to plant and machinery acquired July

1, 1945 to June 30, 1950, by permitting an immediate write-off of 20 per cent of the cost. (I.T.A.A. sec. 57A) (Gunn, pp. 94-95)

b. A special rate of $33\frac{1}{3}$ per cent a year is allowed with respect to plant and equipment used for providing clothing lockers, first aid, rest room or recreation facilities, or meals or facilities for meals for employees. (I.T.A.A. sec. 55 [2]) (Gunn, pp. 97-98) (Form C, Instruction 6)

VIII-B3. *Canada*.—No provision found.

VIII-B4. *Great Britain*.—An initial allowance of 10 per cent is allowed with respect to capital expenditures after April 6, 1944, for industrial buildings (see IV-A4 for definition) and construction of mining works, and 20 per cent for machinery and plant, fixtures, fittings, etc. The allowance is granted to new and second hand machinery and plant but only to new buildings. (I.T.A., 1945, sec. 1, 15, 26) (Spicer, pp. 197-8, 202)

VIII-B5. *New Zealand*.—A special depreciation allowance in addition to regular annual allowances may be granted by the Commissioner with respect to buildings, plant and machinery acquired, erected, installed or extended between April 1, 1945, and March 31, 1948. The special allowance will be granted for all new plant and buildings used in the production of taxable income, and in particular circumstances it will apply to second hand plant. The special allowance will be 30 per cent of the cost spread over five years as follows: 1st year—10 per cent; 2nd year—8 per cent; 3rd year—6 per cent; 4th year—4 per cent; 5th year—2 per cent. The special allowance will extend to farm plant and new farm buildings (though only one-fourth of cost of farmer's residence will qualify). (L.I.T.A., 1945, sec. 15; F.A. [no. 2] 1947, sec. 11)

VIII-B6. *South Africa*.—New machinery ordered within two years ending June 30, 1947, is entitled to a single special 15 per cent allowance in the year in which such machinery appears as an asset on the books of the taxpayer. Wear and tear allowances are computed on the original cost less 15 per cent. (Act 31 of 1941, sec. 11 [2] [d]) (Act 55 of 1946) (Silke, p. 26)

VIII-C. SPECIAL TREATMENT OF EXPENDITURES FOR SCIENTIFIC RESEARCH

VIII-C1. *United States*.—No provision found. It should be noted, however, that costs of research regularly carried on to improve products manufactured are deductible.

VIII-C2. *Australia*.—Expenditures for scientific research may be taken (1) entirely in year of expenditure when made in form of payments to approved research institutes and other expenditures but not including those for plant, machinery, land or buildings; (2) one-third in each of three years for expenditures on buildings, plant, and equipment for scientific research. (Gunn, pp. 81-82) (Form C, Instruction 24)

VIII-C3. *Canada*.—Capital expenditures on scientific research related to the business and directly undertaken by the taxpayer, or on behalf of the taxpayer, may be apportioned one-third to the year of payment, and one-third to each of the two succeeding years. (I.W.T.A., sec. 5 [1] [u])

VIII-C4. *Great Britain*.—Capital expenditures by a trader for scientific research (e.g. on provision of laboratories, pilot plants or other equipment) related to the trader's business or business which he subsequently starts are allowable for income tax purposes in five equal annual installments. (F.A. 1944, sec. 28-31; I.T.A., 1945, sec. 45)

VIII-C5. *New Zealand*.—A deduction for scientific research relating to taxpayer's trade or business may be allowed by the Commissioner in such amount as he deems fit. (L.I.T.A., 1945, sec. 14)

VIII-C6. *South Africa*.—Capital expenditures for scientific research may be written off 25 per cent each year. (Act 31 of 1941, sec. 11 [2] [J]) (Silke, p. 22) (Act 55 of 1946)

VIII-D. SPECIAL TREATMENT OF WAR FACILITIES

VIII-D1. *United States*.—Rapid writing off of emergency wartime facilities was provided by the Revenue Acts of 1918, 1921, and the Second Revenue Act of 1940. The 1940 act, which in general was essentially the same as the earlier acts, assured taxpayers who expanded their facilities beyond normal needs in order to produce for the war effort, that extra facilities could be amortized over their productive life rather than over the longer regular depreciation period. Under the law, taxpayers holding a certificate as to the national defense character of the facility could write off the value thereof over a 60-month period. Where the facility became unnecessary to the war effort within the 60-month period, the cost could be amortized over the shorter period and the assessments for prior years recomputed. (I.R.C., sec. 124)

VIII-D2. *Australia*

a. Where the depreciation allowed with respect to machinery, etc., installed after June 30, 1938, and used in connection with the war, was inadequate, the Board of Referees would examine the allowance made upon application filed within two years after termination of the war. The Board had to be satisfied that the property was scrapped, sold, or otherwise disposed of within two years after the end of the war, or that its value on June 30 after the end of the war was less than the depreciated value, or that its effective life was shorter than that estimated by the Commissioner. The depreciation would then be recomputed in accord with the Board's findings, and the assessments for the war years revised to reflect the increased depreciation. (I.T.A.A., sec. 59A) (Gunn, p. 103)

b. Where any building constructed or acquired after June 30, 1938, decreased in value wholly or mainly as a consequence of the war, the Board

of Referees, on application filed within one year after end of the war, distributed the loss proportionately and the assessments for those years were revised to reflect the allowance. (I.T.A.A. sec. 59B) (Gunn, p. 104)

VIII-D3. *Canada*

a. Extra depreciation was allowed in the case of plant and equipment built or acquired to fulfill orders for war purposes. (I.W.T.A., sec. 6 [1] [n] [i]) Pursuant to this statute and an order in council, a War Contracts Depreciation Board was created to regulate and govern the extra allowances. (Order in Council No. 4217, *Canada Gazette*, September 7, 1940, p. 782; Order in Council No. 7121, *Canada Gazette*, February 8, 1941, p. 2812; Order in Council No. 8593, *Canada Gazette*, September 23, 1942, October 2, 1942 [Extra])

b. To conserve Canada's supply of foreign exchange, it was enacted that agreements could be entered into with producers of goods for export, under which tax credits or other special allowances for depreciation or depletion would be granted with respect to capital extensions or improvements designed to produce exportable goods. (Stat. 1940-41, c. 2, sec. 8; Stat. 1940-41 2nd Sess., c. 29, sec. 2) (C.C.H., para. 10-688.04) (See also VII-A3a; VII-A3b)

VIII-D4. *Great Britain*.—Exceptional depreciation allowances were granted to cover extra depreciation which might be expected due to the rearmament and war programs subsequent to December 31, 1936. If buildings, machinery or plant so used either had no value on December 31, 1946, or a value less than net cost, or were sold before that date for less than net cost, and the deficiency was wholly or mainly attributable as a consequence of the war, then such deficiency could be apportioned over the years from April 6, 1939 (or the later date of providing the asset) to December 31, 1946, date of sale, or the date of final disuser, whichever was earliest. (F.A. 1941, sec. 19; I.T.A., 1945, sec. 48-54; F.A. 1945 [no. 2], sec. 58, 59, 8th Sch.; F.A. 1946, sec. 58) (Spicer, pp. 178-182) (*Accountant Tax Supp.*, September 27, 1947, p. 146, October 4, 1947, pp. 149-150)

VIII-D5. *New Zealand*.—Where machinery or plant was installed for war purposes, the taxpayer was entitled to take depreciation at a rate fixed on the assumption that the war would continue until the property was worn out or discarded for that reason. When the use for war purposes was discontinued and the property sold or scrapped, any residual loss was spread over the years still open to reassessment and refund. When use was continued after the war on a type of work for which inferior machinery could ordinarily be used, the difference between the written down value and the value of the ordinary machinery was apportioned over the years still open to reassessment and refund. When use was continued after the war on a type

of work for which similar machinery would in ordinary use be required, no adjustments were made. When the machinery was sold after war use for a sum in excess of the written down value, the excess depreciation was adjusted over the years still open to reassessment. (Cunningham, pp. 482-483)

VIII-D6. *South Africa*.—No provision found.

IX. TAX BENEFIT RULE

IX-1. *United States*

a. A taxpayer must take depreciation allowable in any year even though no tax benefit results. Depreciation can not be accumulated and held for use in a year which will bring the taxpayer the most tax benefit. If the taxpayer fails to take depreciation in any year, or takes less depreciation than is allowable, he may not make up the deficiency in a later year by taking an increased amount. (Reg. 111, sec. 29.23 [1]-5) (*Virginia Hotel Corp. v. Helvering*, 319 U.S. 523)

b. Some relief, however, is provided in the law which authorizes the carrying forward or carrying back of losses and allowing them as a deduction against income of the two preceding or two following years. (I.R.C., sec. 122)

IX-2. *Australia*

a. Apparently no general provision exists to care for cases where depreciation taken does not result in an effective reduction of tax. However, in 1947, a special provision was adopted for the mining industry. If in any year the allowed depreciation with respect to capital expended on plant and development of mining property is less than the income of that year, the taxpayer may be allowed a deduction up to the amount of his income and be permitted to carry forward the balance for deduction in future years. (I.T.A.A., sec. 122; I.T.A.A., 1947, clause 19) (Taxation Institute of Australia Circular No. 110, p. 27)

b. A general provision allows the carrying forward of losses for seven years, and permits their deduction from income of those years. (I.T.A.A., sec. 80; I.T.A.A., 1947, clause 15)

IX-3. *Canada*

a. Depreciation can not be postponed in non-profitable periods and larger amounts than the normal depreciation be set up in profitable periods. However, in a year in which a loss is suffered, only 50 per cent of the normal depreciation will be deemed to have been incurred. (McMichael, p. 75) (*Canadian Chartered Accountant*, May, 1938, p. 385) If during a year of profit, taxpayer fails to take full depreciation, and the assessment for that year can not be reopened, the depreciation sustained but not written off, up to the extent of the profit realized, will be allowed as a deduction in a subsequent taxable period. (McMichael, p. 75)

b. A general provision allows the carrying back of losses for one year and carrying forward for three years. (I.W.T.A., sec. 5 [1] [p])

IX-4. *Great Britain*

a. If income in any year is less than the initial allowance or the annual allowance for depreciation, the balance may be carried forward indefinitely and be a charge against income of the same person from the same source in succeeding years without limit. Where there is a change of ownership, the successor can not claim his predecessor's unexhausted wear and tear allowances, except in the case of a partnership treated as a continuance of the same business. (I.T.A., 1945, sec. 6, 55, 56) (Spicer, pp. 163, 166-167, 239)

b. A general provision allows the carrying forward of losses for six years (this would normally mean only five assessment years), and permits their deduction against income for those years. When any of the six years to which a loss could be carried forward included the war years 1939-1940 to 1945-1946, the time limit is extended by a number of years equal to any of such years as followed the loss. (F.A. 1926, sec. 33; F.A. [No. 2] 1945, sec. 22) This provision, however, would not be applicable in the case of depreciation because of the special provision above (see IX-4a).

IX-5. *New Zealand*

a. A taxpayer in any year may claim less depreciation than the amount that would be allowed under schedule rates. He may take either the schedule rates or the amount he actually writes off on his books whichever is less. If he writes off in any year more than the schedule rates, the amount of the excess will be carried forward and treated as a writing off for the following year to the extent the writing off for the latter year is less than the amount computed at the schedule rate. (Cunningham, p. 477)

b. A general provision allows the carrying forward of losses for three years, and permits their deduction from income of those years. (I.T.A.A., sec. 81)

IX-6. *South Africa*

a. Actual wear and tear must be deducted in the tax year. (Act 31 of 1941, sec. 11 [2] [d]) The Tax Court has recently ruled that a taxpayer who took underdepreciation in a particular year could not make it up in a later year, because the allowance for loss due to wear and tear in any year was limited to the wear and tear of that year. (Income Tax Case No. 311, 8 S.A.T.C. 152)

b. A general provision allows the carrying forward of any balance of assessed loss incurred by the taxpayer in any previous year which has been carried forward from the preceding year of assessment. (Act 31 of 1941, sec. 11 [3])

X. SALE OR OTHER DISPOSITION OF DEPRECIATED PROPERTY (Note: United States is the only country under consideration taxing capital gains)

X-1. *United States*.—When depreciated property is

sold for more than its depreciated value, the excess is taxable as a capital gain, and therefore subject to the special provisions and limitations on taxation of capital gains. If such property is sold for less than its depreciated value, the difference is treated as an ordinary loss and deductible in full. If a building is razed or old equipment scrapped as an incident to replacement, the resulting loss is deductible. Where depreciable property is disposed of due to causes other than exhaustion, wear and tear, and normal obsolescence, such as casualty, obsolescence other than normal, or sale, a deduction is allowed for the difference between the depreciated value and its salvage value or amount realized upon sale, if it is clearly evident that such disposition was not contemplated in the rate of depreciation. (Reg. 111, sec. 29.23 [e] [f]; sec. 29.117-7)

X-2. *Australia*.—When depreciated property is sold for more than its depreciated value, the excess (but not more than the depreciation previously taken) is included in income. Where the property is sold for less than the depreciated value, or is scrapped, lost or destroyed, the depreciated value, less the amount of any consideration receivable, is an allowable deduction. (I.T.A.A. sec. 59 [1] [2]) Where property was lost or destroyed during World War II and insurance or other recoveries with respect thereto would ordinarily be included in income (because in excess of the depreciated value), the Commissioner (at the request of the taxpayer) may reduce the value of the replacement property or any other property by the amount of the taxable income or the sum of the depreciated values of such other property, whichever is less, and exclude such income from tax. If the replacement is not effected in the year of income, but is effected within two years after the end of the war, the value of the replacement property may be reduced as above and the assessment of the year in which the insurance or other recoveries was received will be amended accordingly. (I.T.A.A., sec. 59 [2A] [2B] [2C]) (Gunn, pp. 100-102)

X-3. *Canada*

a. Generally, where depreciated property is scrapped or sold for a price above or below the depreciated value, no income or deduction is recognized. However, losses in the case of industrial and commercial motor cars and trucks subject to heavy wear, and other delivery equipment such as horses and wagons, are deductible, and gains are includible in income. (McMichael, pp. 49, 74) (C.C.H., para. 10-624.05, 10-690, 10-693)

b. Where (a) immovable assets (not including machinery or equipment) on which special depreciation has been allowed under section 6 (1) (n) (i) (see VIII-D3a) and any other special depreciation or allowances in lieu of depreciation except depreciation under section 6 (1) (n) (ii) (see VII-A3b),

or (b) plant or equipment on which special depreciation has been allowed under section 6 (1) (n) (ii) (see VII-A3b), are sold, the vendor's assessments for the years in which such special depreciation was allowed may be revised by disallowing as a deduction a pro rata portion of such special depreciation to the extent of the excess of selling price over the depreciated cost, less depreciation normally allowed, and less the excess (if any) of the selling price over the undepreciated cost. (I.W.T.A., sec. 6 [1] [n])

X-4. *Great Britain*

a. Where an industrial building (see IV-A4 for definition) is sold, destroyed or permanently put out of use, an additional deduction may be claimed if the amount realized by the sale, insurance, salvage, etc. is less than the depreciated value. However, if such amount realized exceeds the depreciated value, the excess (but not more than the total of depreciation and other allowances theretofore taken) is included as taxable income. No deduction from, or addition to, income will be made after the fiftieth year of assessment. (I.T.A., 1945, sec. 3)

b. Where machinery or plant is scrapped, sold or destroyed before the business or employment comes to an end, a balancing allowance may be made equal to the amount of the capital expenditure on the machinery or plant which has not been allowed, less any proceeds of sale, insurance or salvage moneys, or compensation received in respect of the machinery or plant. If the sale proceeds, insurance moneys, etc., exceed the depreciated value, the excess (but not more than the total of depreciation and other allowances theretofore taken) is included as taxable income (I.T.A., 1945, sec. 17), or deducted from the capital expenditure on the new machinery or plant. (I.T.A., 1945, sec. 18)

X-5. *New Zealand*

a. When depreciated assets are sold at a price in excess of the depreciated value, the depreciation previously allowed may be reviewed and the tax recovered. This may be done at any time without respect to the statute of limitations on time for amending assessments. (L.I.T.A., sec. 80 [1] [a]; L.I.T.A. 1945, sec. 16)

b. If the property (excluding buildings) is sold for less than the depreciated value, or if discarded before full depreciation has been taken, a further claim may be made in the year of sale or discard. No such additional allowance will be made with respect to the sale, discarding or demolition of a building. A loss incurred in the disposal of assets consequent upon ceasing to carry on the business will not be allowed in full. (Cunningham, p. 478; L.I.T. Form 3B, p. 6, 8 [D])

X-6. *South Africa*.—Where depreciated property is scrapped or sold for less than its depreciated value, a further allowance is made equal to the excess of the cost over the sum of wear and tear

allowances previously taken and receipts from the sale or other disposition of the article. The allowance is permitted only when the taxpayer continues in business. It can be claimed only in the year in which the article is disposed of. If the sale price exceeds the original cost, the tax applies only to the wear and tear allowances previously claimed; the excess of the sale price over the original cost would be capital gain and therefore exempt. (Barnes, pp. 101-102) (Silke, p. 23) (*Moorreesbury Produce Co. v. Commissioner*, 13 S.A.T.C. 245) (Income Tax Cases Nos. 559 and 565, 13 S.A.T.C. 306, 330)

XI. ABBREVIATIONS

XI-1. United States

Bulletin "F"—U.S. Treasury Department, Bureau of Internal Revenue. Bulletin "F". *Income Tax Depreciation and Obsolescence Estimated Lives and Depreciation Rates* (Washington: Government Printing Office, 1942).

I.R.C.—*Internal Revenue Code*. Title 26 of U.S. Code.

Mim. 6030—*Internal Revenue Bulletin*, July 15, 1946.

Reg. 111—U.S. Treasury Department, Bureau of Internal Revenue. *Regulations 111* (Washington: Government Printing Office, 1943).

XI-2. Australia

Form C—Return of Income Derived from all sources . . . during the 12 months from 1st July, 1946 to 30th June, 1947.

Gunn—J. A. L. Gunn and R. E. O'Neill. *Guide to Commonwealth Income Tax*. (2nd ed. Sydney: Butterworth and Co., 1947).

I.T.A.A.—Income Tax Assessment Act 1936, as amended.

I.T.O. 1217—Income Tax Order No. 1217.

Ratcliffe—J. V. Ratcliffe, J. Y. McGrath, and J. W. R. Hughes. *The Law of Income Tax* (Sydney: Law Book Co. of Australasia, 1938) and Cumulative Supplement (December, 1945).

XI-3. Canada

C. C. H.—*Canadian Tax Service* (Chicago: Commerce Clearing House). (This looseleaf service has been discontinued.)

I. W. T. A.—Income War Tax Act, 1917, as amended.

McMichael—A. R. McMichael. *Your Income Tax* (Toronto: Musson Book Co., 1947).

Smith—Lancelot J. Smith. *How to Prepare Your Income Tax* (Toronto: William Collins Sons and Co., 1944).

XI-4. Great Britain

B. I. R. Leaflets—Board of Inland Revenue Leaflets. (A number of these leaflets explain various aspects of the Income Tax Act of 1945.)

F. A.—Finance Act (of particular year).

I. T. A., 1945—Income Tax Act, 1945.

Konstam—E. M. Konstam. *The Law of Income Tax* (10th ed. London: Stevens and Sons, 1946).

Spicer—Ernest E. Spicer and Ernest C. Pegler. *Income Tax* (17th ed. London: H. F. L. [Publishers, 1947]). This edition is by H. A. R. J. Wilson.

XI-5. New Zealand

Cunningham—H. A. Cunningham and C. E. Dowland. *Taxation Law of New Zealand* (2nd ed. Wellington: Butterworth and Co., 1942).

F. A.—Finance Act (of particular year).

Form 3A or 3B—Return of Income during the year ended 31st March, 1947.

Handbook—*Handbook to Income Tax* (Christchurch: Whitcomb and Tombs, 1944).

L. I. T. A.—Land and Income Tax Act, 1923 (or of year indicated).

XI-6. South Africa

Barnes—Walter J. Barnes. *Barnes' Income Tax Handbook* (5th ed. Durban: Butterworth and Co., 1944). This edition is by A. W. Osborn.

S. A. T. C.—South African Tax Cases.

Silke—A. S. Silke. *Illustrations to Income Tax* (1947). (2nd ed. Capetown: Juta and Co., 1947).

Social and Economic Planning Council—*Taxation and Fiscal Policy*. (Report No. 7) (Pretoria: Government Printer, 1945).

POSTWAR CHANGES IN INDIVIDUAL INCOME TAXES: UNITED STATES, UNITED KINGDOM, AND CANADA

GENEVIEVE E. HUGHES *

THE FOLLOWING tables compare the postwar changes in the individual income taxes of the United States, the United Kingdom, and Canada.

Tables 1 and 2 give summary information with respect to the individual income tax rates, exemptions, and credits in each country under the highest wartime taxes and under present law.

Tables 3 and 4 show the amounts and effective rates of individual income tax for single persons with no dependents and married persons with two dependents, for selected amounts of net income.

These data are subject to the limitations which apply to international tax comparisons. Certain differences in the taxation of incomes in the three countries, not reflected in these tables, should be noted. The difference between the British and the United States and Canadian methods of taxing dividends is highly important. The British consider the income tax at the standard rate (45 per cent) paid by the corporation on its profits as a payment on behalf of the stockholder. If the stockholder is liable to the reduced normal tax rates (15 per cent on first \$200, 30 per cent on next

\$800) instead of standard rate, he is entitled to claim a refund. For normal tax the stockholder is not required to include the dividends in his taxable income since the tax is paid at source. However, for surtax he must include not only the dividends actually received but also the tax paid by the corporation with respect to the dividends.

The methods of taxing capital gains and losses also differ; the Canadians in general follow the British practice of disregarding gains and losses from certain casual or isolated transactions not connected with the taxpayer's trade or business; the United States includes capital gains and losses in income to varying degree but provides that the tax rate on gains from capital assets held more than six months shall not exceed a maximum of 25 per cent. Capital losses may be offset against ordinary income to the extent of \$1,000 each year and a 5-year carry-over of unabsorbed capital losses is allowed.

The definitions of the taxpayer unit of "gross income" and "net income" vary considerably. The British, for example, require husbands and wives to file joint returns, grant virtually no exemption to interest on government bonds, include in gross income the rental value of a dwelling occupied by the owner, and do not allow the deduction of charitable contributions.

Finally, it should be noted that income tax comparisons do not represent comparisons of the total tax burdens for the three countries.

* The author is employed as an economist in the Division of Tax Research, United States Treasury Department. However, the responsibility for material included in the article is her own, and the presentation of any topics here discussed does not in any way reflect the views or policy of the Treasury Department.

TABLE 1

SUMMARY COMPARISON OF INDIVIDUAL INCOME TAX RATES, EXEMPTIONS, AND CREDITS UNDER
HIGHEST WARTIME TAXES ¹ IN THE UNITED STATES, UNITED KINGDOM, AND CANADA

	United States (1944-45)	United Kingdom ² (1942-46)	Canada (1942-44)
Personal exemptions:			
Single person	³ \$ 500	⁴ \$320	⁵ \$660
Married person	³ 1,000	⁶ 560	⁵ \$660 plus a tax credit of \$150 from graduated tax
Credit for dependents	³ 500	⁷ 200	Tax credit of (a) \$28 from normal tax and (b) \$80 from graduated tax ⁷
Earned income credit	None	10% of earned net income; maximum ⁸ \$600	See special surtax on investment income
Normal tax ⁹	3%	First \$660, 32.5% Balance over \$660, 50%	Married person: ¹⁰ 7% on total net income in excess of \$1,200 Single person: ¹⁰ 7% on total net income in excess of \$660 but not over \$1,800; 8% on total net income in excess of \$1,800 but not over \$3,000; 9% on total net income in excess of \$3,000
Surtax: ¹¹			
Minimum rate	20%	10%	30%
Maximum rate	91% ¹²	47.5%	85%
Minimum rate applies to	First \$ 2,000	\$8,000-\$10,000	First \$500
Maximum rate applies to	Over \$200,000	Over \$80,000	Over \$100,000
Special surtax on investment income	.....	.....	4% on all investment income in excess of \$1,500
Postwar credit ¹³	.....	The difference in normal tax at above rates; computed on the basis of (a) prior law exemptions and credits and (b) the above exemptions and credits ¹⁴	One-half of total taxes payable under the normal tax and graduated tax rates, but not to exceed in the case of: (a) single person, 8% of net income or \$800, whichever is less; (b) married person, 10% of net income or \$1,000, whichever is less; (c) each dependent, 1% of net income or \$100, whichever is less

For footnotes, see pages 182-3.

TABLE 2

SUMMARY COMPARISON OF INDIVIDUAL INCOME TAX RATES, EXEMPTIONS, AND CREDITS UNDER
PRESENT LAW ¹⁵ IN THE UNITED STATES, UNITED KINGDOM, AND CANADA

	United States	United Kingdom ²	Canada
Personal exemp- tions:			
Single person	\$ 600	¹⁶ \$440	\$ 750
Married person	1,200	¹⁷ 720	¹⁸ 1,500
Credit for depen- dents	600	¹⁹ 240	\$100, if eligible for family allowances; \$300, if not eligible for family allowances ²⁰
Additional exemp- tions: ²¹			
For the blind	\$ 600	.....	\$480
For persons 65 years of age	600	.....	500
Earned income credit	None	20% of earned net in- come; ²² maximum \$1,600	See special surtax on investment income
Tax rates	Combined normal tax and surtax after re- ductions from tenta- tive rates: ^{23, 24} 16.60% on first \$2,- 000 of surtax net in- come up to 82.1275% on excess over \$200,- 000 ²⁵	Normal tax: First \$200, 15% Next \$800, 30% Balance over \$1,000, 45% Surtax: ²⁴ 10% on first \$2,000 of surtax net income in excess of \$8,000, up to 52.5% on ex- cess over \$80,000	Graduated tax: ²⁴ 10% on first \$100 of taxable income up to 80% on excess over \$250,000
Special surtax on investment income	.....	10% on first \$1,000 of investment income in excess of \$1,000, provided total in- come exceeds \$8,000, up to 50% on excess over \$20,000 ²⁶	4% on all investment income in excess of \$1,800

For footnotes, see pages 182-3.

TABLE 3
AMOUNTS OF INDIVIDUAL INCOME TAX LIABILITIES FOR THE UNITED STATES, UNITED KINGDOM, AND CANADA UNDER HIGHEST
WARTIME TAXES AND UNDER PRESENT LAW TAXES 27
Part A: *Single person, no dependents*

Net Income Before Personal Exemption	United States			United Kingdom 2, 28			Canada 29		
	Wartime High (1944-45)	Present Law (1948)	Decrease	Wartime High (1942-46) 30	Present Law (1949) 31	Decrease	Wartime High (1942-44) 32	Present Law (1948) 31	Decrease
\$ 500	\$ 23	.....	\$ 23	\$ 42	.....	\$ 42	.....	.....	.....
600	69	33	36	72	6	66	47	5	42
800	115	66	49	130	30	100	\$ 47	\$ 5	\$ 42
1,000	161	100	61	189	78	111	92	29	63
1,200	230	149	81	265	126	139	151	61	90
1,500	345	232	113	400	198	202	247	120	127
2,000	585	409	176	625	342	283	441	220	221
3,000	835	603	232	1,075	702	373	824	420	404
4,000	1,105	811	294	1,525	1,062	463	1,274	620	654
5,000	1,395	1,040	355	1,975	1,422	553	1,728	835	893
6,000	2,035	1,546	489	2,425	1,782	643	2,205	1,065	1,140
8,000	2,755	2,124	631	3,425	2,502	923	3,225	1,615	1,610
10,000	4,930	3,894	1,036	4,625	3,602	1,023	4,312	2,253	2,059
15,000	10,590	8,600	1,990	7,837	6,627	1,210	7,579	4,153	3,426
25,000	27,945	23,201	4,744	15,137	13,627	1,510	14,696	9,015	5,681
50,000	69,870	58,762	11,108	36,575	34,502	2,073	34,903	23,456	11,447
100,000	209,350	179,831	29,519	84,200	82,252	1,948	80,337	56,631	23,706
250,000	444,350	385,000	59,350	230,450	228,502	1,948	227,304	172,556	54,748
500,000	33 675,000	33 577,500	97,500	474,200	472,252	1,948	472,304	382,518	89,786
750,000	33 900,000	33 770,000	130,000	717,950	716,002	1,948	717,304	592,518	124,786
1,000,000				961,700	959,752	1,948	962,304	802,518	159,786

For footnotes, see pages 182-3.

TABLE 3—Continued
Part B: Married person, 34 two dependents

Net Income Before Personal Exemption	United States			United Kingdom 2, 28			Canada 29		
	Wartime High (1944-45)	Present Law (1948)	Decrease	Wartime High (1942-46) 30	Present Law (1949) 31	Decrease	Wartime High (1942-44) 32	Present Law (1948) 31	Decrease
\$ 600	\$ 3	.....	\$ 3	.....	\$ -52	*	.....	\$ -144	*
800	9	.....	9	.....	-52	*	.....	-144	*
1,000	15	.....	15	.....	-52	*	.....	-144	*
1,200	21	.....	21	.....	-52	*	.....	-144	*
1,500	30	.....	30	.....	-46	*	.....	-144	*
2,000	45	.....	45	.....	50	\$ 255	.....	-108	*
3,000	275	.....	175	.....	327	428	.....	86	\$ 248
4,000	505	.....	239	.....	687	518	.....	286	382
5,000	755	.....	323	.....	1,047	608	.....	486	576
6,000	1,005	.....	407	.....	1,407	698	.....	702	777
8,000	1,585	.....	611	.....	2,137	968	.....	1,194	1,185
10,000	2,245	.....	884	.....	3,238	1,067	.....	1,786	1,560
15,000	4,265	.....	1,753	.....	6,266	1,251	.....	3,616	2,897
25,000	9,705	.....	4,229	.....	13,273	1,544	.....	8,396	5,034
50,000	26,865	.....	10,287	.....	34,156	2,099	.....	22,789	10,348
100,000	68,565	.....	22,922	.....	81,909	1,971	.....	55,869	21,702
250,000	207,985	.....	52,261	.....	228,159	1,971	.....	171,099	49,839
500,000	442,985	.....	84,308	.....	471,909	1,971	.....	381,614	79,924
750,000	675,000	.....	111,005	.....	715,659	1,971	.....	591,614	109,924
1,000,000	900,000	.....	130,686	.....	959,409	1,971	.....	801,614	139,924

For footnotes, see pages 182-3.

TABLE 4
EFFECTIVE RATES OF INDIVIDUAL INCOME TAX FOR THE UNITED STATES, UNITED KINGDOM, AND CANADA UNDER
HIGHEST WARTIME TAXES AND UNDER PRESENT LAW TAXES 27
Part A: *Single person, no dependents*

Net Income Before Personal Exemption	United States				United Kingdom 2, 28				Canada 29			
	Wartime High (1944-45)	Present Law (1948)	Percentage- Point Decrease	Wartime High (1942-46) 30	Present Law (1949) 31	Percentage- Point Decrease	Wartime High (1942-44) 32	Present Law (1948) 31	Percentage- Point Decrease	Wartime High (1942-44) 32	Present Law (1948) 31	Percentage- Point Decrease
\$ 500	...	...	...	8.4%	...	8.4%	...	...	...	...	...	...
600	3.8%	...	3.8%	12.0	1.0%	11.0	...	...	...	...	...	...
800	8.6	4.2%	4.5	16.3	3.8	12.5	5.9%	0.6%	5.3%	...	...	...
1,000	11.5	6.6	4.9	18.9	7.8	11.1	9.2	2.9	6.3	...	...	...
1,200	13.4	8.3	5.1	22.1	10.5	11.6	12.6	5.1	7.5	...	...	...
1,500	15.3	10.0	5.4	26.7	13.2	13.5	16.5	8.0	8.5	...	...	...
2,000	17.3	11.6	5.7	31.3	17.1	14.2	22.1	11.0	11.1	...	...	...
3,000	19.5	13.6	5.9	35.8	23.4	12.4	27.5	14.0	13.5	...	...	...
4,000	20.9	15.1	5.8	38.1	26.6	11.6	31.9	15.5	16.4	...	...	...
5,000	22.1	16.2	5.9	39.5	28.4	11.1	34.6	16.7	17.0	...	...	...
6,000	23.3	17.3	5.9	40.4	29.7	10.7	36.8	17.8	19.0	...	...	...
8,000	25.4	19.3	6.1	42.8	31.3	11.5	40.3	20.2	20.1	...	...	...
10,000	27.6	21.2	6.3	46.3	36.0	10.2	43.1	22.5	20.6	...	...	...
15,000	32.9	26.0	6.9	52.2	44.2	8.1	50.5	27.7	22.8	...	...	...
25,000	42.4	34.4	8.0	60.5	54.5	6.0	58.8	36.1	22.7	...	...	...
50,000	55.9	46.4	9.5	73.2	69.0	4.1	69.8	46.9	22.9	...	...	...
100,000	69.9	58.8	11.1	84.2	82.3	1.9	80.3	56.6	23.7	...	...	...
250,000	83.7	71.9	11.8	92.2	91.4	.8	90.9	69.0	21.9	...	...	...
500,000	88.9	33 77.0	11.9	94.8	94.5	.4	94.5	76.5	18.0	...	...	...
750,000	33 90.0	33 77.0	13.0	95.7	95.5	.3	95.6	79.0	16.6	...	...	...
1,000,000	33 90.0	33 77.0	13.0	96.2	96.0	.2	96.2	80.3	16.0	...	...	...

For footnotes, see pages 182-3.

TABLE 4—Continued
Part B: Married person,³⁴ two dependents

Net Income Before Personal Exemption	United States				United Kingdom 2, 28				Canada 29			
	Wartime High (1944-45)	Present Law (1948)	Percentage- Point Decrease	Percentage- Point Decrease	Wartime High (1942-46) 30	Present Law (1949) 31	Percentage- Point Decrease	Percentage- Point Decrease	Wartime High (1942-44) 32	Present Law (1948) 31	Percentage- Point Decrease	Percentage- Point Decrease
\$ 600	0.5%	...	0.5%	...	...	-8.7%	*	*	...	-24.0%	*	*
800	1.1	...	1.1	...	...	-6.5	*	*	...	-18.0	*	*
1,000	1.5	...	1.5	...	...	-5.2	*	*	...	-14.4	*	*
1,200	1.8	...	1.8	...	...	-4.3	*	*	...	-12.0	*	*
1,500	2.0	...	2.0	...	8.5	-3.1	*	*	...	-9.6	*	*
2,000	2.3	...	2.3	...	15.3	2.5	12.8%	*	...	-	*	*
3,000	9.2	3.3%	5.8	...	25.2	10.9	14.3	8.3%	5.4	-	8.3%	8.3%
4,000	12.6	6.6	6.0	...	30.1	17.2	13.0	9.6	11.1	2.9	9.6	9.6
5,000	15.1	8.6	6.5	...	33.1	20.9	12.2	11.5	16.7	7.2	11.5	11.5
6,000	16.8	10.0	6.8	...	35.1	23.4	11.6	13.0	21.2	9.7	13.0	13.0
8,000	19.8	12.2	7.6	...	38.8	26.7	12.1	14.8	24.7	11.7	14.8	14.8
10,000	22.5	13.6	8.8	...	43.1	32.4	10.7	15.6	29.7	14.9	15.6	15.6
15,000	28.4	16.7	11.7	...	50.1	41.8	8.3	19.3	33.5	17.9	19.3	19.3
25,000	38.8	21.9	16.9	...	59.3	53.1	6.2	20.1	43.4	24.1	20.1	20.1
50,000	53.7	33.2	20.6	...	72.5	68.3	4.2	20.7	53.7	33.6	20.7	20.7
100,000	68.6	45.6	22.9	...	83.9	81.9	2.0	21.7	66.3	45.6	21.7	21.7
250,000	83.2	62.3	20.9	...	92.1	91.3	.8	19.9	77.6	55.9	19.9	19.9
500,000	88.6	71.7	16.9	...	94.8	94.4	.4	16.0	88.6	68.7	16.0	16.0
750,000	33 90.0	75.2	14.8	...	95.7	95.4	.3	14.7	92.3	76.3	14.7	14.7
1,000,000	33 90.0	76.9	13.1	...	96.1	95.9	.2	14.0	93.5	78.9	14.0	14.0
									94.2	80.2		

For footnotes, see pages 182-3.

Footnotes for Tables 1-4.

¹ United States Internal Revenue Code, as amended by the Individual Income Tax Act of 1944, applicable to the years 1944 and 1945; British Finance Acts (No. 2) 1940, 1941, and 1942, applicable to the years 1941-42 to 1945-46; Canadian Income War Tax Act, as amended by Chapter 43, Statutes of 1944-45, applicable to the years 1942-1944.

² Pound converted at \$4.

³ Surtax exemptions. For surtax, each taxpayer was allowed an exemption of \$500, plus \$500 for his spouse, and \$500 for each dependent. The normal tax exemption was \$500. However, if husband and wife combined their income in a joint return, the normal tax exemption was \$500 plus the amount of the smaller of the two incomes, but not more than \$1,000 for both.

⁴ This was the amount allowed individuals liable to tax. The exemption limit at or below which income tax did not apply, however, was \$440.

⁵ For purposes of the graduated tax.

⁶ If the wife had earned income, the ordinary exemption of \$560 was increased by 90 per cent of the wife's earnings up to a maximum of \$320, making the maximum in such cases \$880.

⁷ Allowance for dependent child, varied in some cases for other types of dependents.

⁸ A taxpayer over 65 years of age at the beginning of the tax year, whose total income did not exceed \$2,000 was allowed a deduction of 10 per cent of his total income, earned and investment.

⁹ Applicable in the United States to net income after normal tax exemption; in the United Kingdom to net income after personal exemption, credit for dependents, and earned income credit; in Canada to total net income in excess of specific exemptions.

¹⁰ In the case of a single person whose taxable income was less than \$820, and a married person whose taxable income was less than \$1,570, the normal tax and graduated tax (i.e., after credit for dependents) could not exceed two-thirds of the amount by which the taxable income exceeded \$660 for a single person, and \$1,200 for a married person.

¹¹ Applicable in the United States to net income after surtax exemptions; in Canada to net income after personal exemptions; but in United Kingdom to net income before exemptions and credits.

¹² The combined normal tax and surtax (before deduction of credits for foreign taxes, taxes withheld at source, and taxes withheld on wages) is limited to 90 per cent of net income for the taxable year.

¹³ In the United Kingdom the taxpayer was not permitted to take the postwar credit currently. In

Canada, the credit ("refundable portion" of the tax) could be taken currently to the extent of (a) contributions to pension or retirement funds, (b) net premiums paid on life insurance policies on the taxpayer's own life or on the lives of the taxpayer's spouse or dependents in force prior to June 23, 1942 (or one-half of the first year's premium, and the whole of subsequent year's premiums but in no year more than \$100 on a policy on taxpayer's own life not in force prior to June 23, 1942), (c) reduction of debt outstanding prior to June 23, 1942, on one residential property, plus (d) certain types of installment savings in effect prior to June 23, 1942, where postponement of payments would result in substantial loss to the taxpayer. A taxpayer over sixty-five years of age with income of less than \$5,000 was exempt from the "refundable portion" of the Canadian tax. The refundable or saving's portion of the Canadian tax, however, was suspended as of July 1, 1944. As a result, the total tax payable for 1944 was reduced by one-half the amount of the refundable portion, less one-half credits for savings; and the total tax for 1945 was reduced by the full amount of the refundable portion, less credits for savings.

¹⁴ Under prior law the personal exemptions were \$400 for single persons and \$680 for married persons and the earned income credit was 16-2/3 per cent (maximum \$1,000). In effect, therefore, the postwar credit for any year could not exceed \$240 for a single person or \$260 for a married person, if all income was earned; and could not exceed \$40 for a single person or \$60 for a married person, if all income was derived from investments.

¹⁵ United States Internal Revenue Code, as amended by the Revenue Act of 1948, applicable to 1948 and subsequent years; British Finance (No. 2) Act of 1945 and Finance Acts of 1946 and 1947, as amended by Budget proposals of April 6, 1948, applicable to the year 1948-49; Canadian Income War Tax Act, as amended by Chapter 55, Statutes of 1946, Chapter 63, Statutes of 1947, and Budget proposals of May 18, 1948, applicable to 1948 and subsequent years.

¹⁶ This is the amount allowed individuals liable to tax. The exemption limit at or below which tax does not apply is \$540, with an appropriate notch provision.

¹⁷ If the wife has earned income, the ordinary exemption of \$720 is increased by four-fifths of the wife's earnings up to a maximum of \$440, making the maximum in such case \$1,160.

¹⁸ If the wife has an income of more than \$250 but not more than \$750, the marital exemption of \$1,500 is reduced by the amount of the wife's income in excess of \$250; if the wife's income is in excess of \$750, the husband and wife are separately taxed as single persons.

19 Allowance for dependent child; varied in some cases for other types of dependents. Since August 6, 1946, a family allowance of \$1 a week or \$52 a year is paid for each child, other than the eldest, under 16 years of age.

20 Allowance for dependent child; varied in some cases for other types of dependents. Family allowances average about \$72 annually per child under 16 years of age.

21 These exemptions are not allowed for dependents.

22 A taxpayer over sixty-five years of age at the beginning of the tax year, whose total income does not exceed \$2,000, is allowed a deduction of 20 per cent of his total income, earned and investment.

23 Married couples filing joint returns may divide their combined incomes equally in computing their income taxes. The tax liability of such couples will be twice the tax liability on half the couple's combined taxable income (after exemptions and deductions).

24 Applicable in the United States and Canada to net income after personal exemption and credit for dependents, but in the United Kingdom to net income before personal exemption and credits.

25 Subject to maximum effective rate limitation of 77 per cent.

26 Applicable to the year 1947-48 only. Where the total income slightly exceeds \$8,000, the tax is limited to the excess of the total income over \$8,000.

27 For sources, see footnotes 1 and 15.

28 For financial years ending April 5. All income is assumed to be earned income. Under the budget proposals of April 6, 1948, a Special Contribution is imposed on the investment income of individuals for the year 1947-48 where the individual's investment income exceeded \$1,000 and his total income exceeded \$8,000 (See Table 2). The amounts and effective rates of individual income tax including the tax on investment income for single persons with no dependents and married

persons with two dependents, for selected amounts of income in 1947-48, assuming all income is investment income, are as follows:

Investment Income	Single Person, No Dependents		Married Person, Two Dependents	
	Amounts of Tax	Effective Rates	Amounts of Tax	Effective Rates
\$ 10,000	\$ 6,497	65.0%	\$ 6,155	61.6%
25,000	22,922	91.7	22,580	90.3
50,000	56,297	112.6	55,955	111.9
100,000	129,047	129.0	128,705	128.7

29 All income in excess of \$30,000 assumed to be investment income. In accordance with the Canadian treatment, taxable income of married persons with dependents does not include family allowances.

30 Total tax liability before postwar credit (not yet generally repayable). The postwar credit was repealed as of April 1, 1946.

31 For a married person with two dependents, United Kingdom and Canadian tax figures under present law represent the net position of a taxpayer with one child and two children of family-allowance age, respectively, reflecting the combined effect of receipt of family allowances and payment of income tax. For the United Kingdom computations assume that one child under 16 years of age is eligible for the family-allowance payments at the rate of \$1 per week (\$52 per year). For Canada assumes family-allowance payments of \$144 (\$72 per child). Minus signs indicate that family allowances exceed the income tax by the amounts shown.

32 Net tax liability after postwar credit which could be taken currently. The postwar credit was repealed as of July 1, 1944.

33 Taking into account maximum effective rate limitations of 90 per cent for 1944-45 and 77 per cent for 1948.

34 Assumes only one spouse has income.

DENVER ADOPTS LOCAL SALES TAX

BYRON L. JOHNSON *

AFTER a year of consideration, the Denver city council voted in December, 1947, to adopt a local sales tax, similar to that imposed by the State of Colorado, but at a rate of 1 per cent instead of the 2 per cent State rate.

First serious consideration of a local sales tax began in December, 1946, when then-mayor Stapleton suggested such a tax to balance the city's budget. A local payroll tax such as is used in Philadelphia and Toledo was also suggested at that time.

Labor and business groups joined in opposing any additional taxes at that time, and an opinion poll conducted by the newspapers disclosed public opposition to both suggestions. Council members preferred to use up balances in certain reserve funds rather than impose the tax at that time.

During 1947 the city elected Quigg Newton mayor, and voted to call a charter convention. Tax questions were held in abeyance pending decision on the resulting proposal for a new charter for the city and county of Denver. In a light special election during November, to the surprise of pollsters, the proposed charter was defeated.

Administrative and fiscal plans had to be redrawn at the last minute, and the city council was again faced with an unbalanced budget, and with property tax rates against the ceiling. Reappraisal of property, now under way, could not possibly solve the problem for the 1948 budget.

The council again turned to consideration of a local sales tax, of a payroll tax, and of an income tax parallel to that of the State. The city estimated that to secure \$4 million annually, the rate of either a payroll tax or

a retail sales tax would need to be 1 per cent. Rough estimates of the yield of a graduated income tax were said to indicate that rates might need to be fully as progressive as the State rates.

Given the foregoing advice, several councilmen felt that a local sales tax was the best choice. Informally, many business groups supported this choice, as did the two local papers. The council passed the first reading of the sales tax without a murmur of dissent.

Protest was vigorous at the following meeting of the council, when second and final reading was to be voted. Organized labor protested the move, as did individual business men whose places of business are near the suburban shopping centers. One alternative suggestion was a local income tax, using a base similar to that of the Federal income tax, with a flat rate of 1 per cent on net taxable income. Advocates of this alternative argued that the city had underestimated the size of the local income base. Organized labor indicated a willingness to accept a local income tax with a personal exemption, but continued its opposition to a local payroll tax, regardless of rate.

The local tax on retail sales became effective January 1, 1948. The strength of taxpayer resistance was apparent to all immediately. Grocery stores in the nearby suburban shopping centers began to do a tremendous volume of business, tax-free, while many local stores noted a sharp drop in business.

Because of the city's desire to follow the State tax, it fixed 1 per cent brackets at the same point as the State "breaks," namely,

* The author is assistant professor of economics at the University of Denver.

at \$.19, \$1.19, \$2.19, etc. The *Denver Post* and citizens generally came to realize that for some sales, the effective rate was not 1 per cent, but 5 per cent, and proposed a change in the brackets.

The tax on food was especially opposed, as falling with greatest severity on those with large families and low incomes, and thus least able to pay. Various business groups, especially those feeling the greatest impact from suburban competition, came out for immediate repeal of the sales tax.

Even during January the council had passed minor amendments designed to exempt sales to buyers living out of town, but required that the seller ship the items by its own truck or common carrier to the buyer's address, so as to prevent wanton evasion of the tax by Denver buyers. The effect of the provision, thus hedged, was to continue to cost Denver merchants many sales to residents of the Rocky Mountain area, who have been accustomed to consider Denver their shopping center.

In an effort to protect local merchants, the administration proposed a use tax, similar to that applied by the State of Colorado. Ridicule, abuse, and threats of non-compliance greeted this proposal. The *Post* published a cartoon of a motorist entering Denver being searched by a "border patrol." The precise wording of the amendment was ignored so as to make it appear more ridiculous. It was suggested that merchants in London would have to take out a license to collect the use tax on sales made to Denverites.

The city council, naturally enough, refused to pass the amendment, and tabled it. Subsequently, the mayor proposed to exempt purchases up to \$25, so that no effort would be made to enforce the use tax except where the liability would exceed \$.25 on any given sale. Even this was tabled by the council.

Early in February, the administration revised its estimates of revenue needs, and suggested that the council exempt foods,

prescription drugs, and meals. Simultaneously, it suggested that the tax exempt sales of less than \$.44, but retained the other brackets: \$.19, \$2.19, etc. The council, which had long favored some such move, adopted the suggestion and added an amendment of its own, that the tax terminate December 31, 1948.

At the time these amendments were voted, various business groups asked for immediate repeal of the sales tax, and at least two of the groups endorsed a local income tax, with a personal exemption, instead. Grocers were torn between welcoming the exemption of foodstuffs, since lost customers might return as a result, and resenting the additional burden of segregating and remitting the tax on the many non-food items found in every grocery store. At least one grocer has offered an automatic 1 per cent discount on non-food items, although this offer may violate the terms of the ordinance. Others may "absent-mindedly" pay the tax themselves, rather than attempt to collect it. Other businesses, upon occasion, have had to absorb the tax rather than lose a sale to a buyer hostile to the tax.

Data on gross sales reported in Denver and in the remainder of the State indicate that during the first three months of 1948, sales in Denver were 7.6 per cent above the same period of 1947. Sales in the rest of the State were 14.3 per cent higher. By contrast, the Denver sales during the fourth quarter of 1947 were 20 per cent higher than in the previous year, while those in the rest of the State were 22 per cent greater. This data has led to charges that during the first three months after the imposition of the tax, Denver merchants lost from \$9 to \$14 million of gross sales to merchants in other communities. In terms of income to Denverites, it has been charged, from \$3 to \$5 million has been lost through the operation of the sales tax.

Federal Reserve Bulletin statistics on department store sales have been cited as additional evidence that the sales tax has cost

Denver merchants heavily. The *Federal Reserve Bulletin* publishes monthly statistics for Denver and Pueblo, the two largest cities in the State. During the first two months of 1948, sales in Denver were 4 per cent higher than in the corresponding period of 1947, while Pueblo sales showed a 19 per cent increase. By contrast, Denver's 1947 increase had been 12 per cent over 1946, while Pueblo's increase in 1947 was only 10 per cent.

Arguments such as those cited above, plus increasing unrest among merchants over administrative costs and problems arising out of the tax have led to the formation of a "Coordinating Committee" of representatives of business, labor, and civic groups whose sole purpose is to secure immediate repeal of the sales tax, by initiative referendum if necessary. If petitions signed by 15 per cent of the voters in the last election (about 21,000), calling for a special election vote upon the issue are filed, a referendum election must be called by the city council, under the terms of the city charter. The coordinating committee anticipates no trouble in getting the necessary signatures, because in a two-week period in February 23,500 signatures were obtained on an informal petition to the mayor and council asking repeal of the tax.

City officials have announced that the sales tax as amended will yield approximately \$3 million this calendar year, or

\$3.3 million including January, 1949, collections on December, 1948, sales. The coordinating committee opposing the sales tax has not agreed upon an alternative to the sales tax, although city officials aver that the revenues provided by the sales tax will need to be replaced if the tax is repealed. Four differing answers have been given. Some members favor an income tax as a replacement; others favor higher property taxes, especially on business properties not subject to rent control; a third group believes that much greater economies in the budget would remove the necessity for additional taxes; and a fourth answer given by the committee to questioning councilmen is that it is up to the council to pass new tax legislation, so long as it is not a retail sales tax.

Meanwhile, a study is under way at the University of Denver to determine the income base in Denver County, so that better estimates can be prepared of the probable yield of alternative provisions in a local income tax. One plan that has been suggested calls for only one deduction from personal income—an exemption of \$624 for each person in a taxpayer's family, and a rate of 1 per cent on remaining income. Withholding would be used for wages and salaries, and quarterly returns for other personal incomes. Incorporated businesses would pay 1 per cent on net income (as defined for Federal purposes) attributable to operations in Denver.

BOOK REVIEWS

The Impact of the Undistributed Profits Tax, 1936-37. By GEORGE E. LENT. New York: Columbia University Press, 1948. Pp. 203. \$2.50.

This very interesting and readable study from Professor Lent's pen is a book which is long overdue.

A full decade has passed since the virtual repeal by the Revenue Act of 1938 of the bitterly controverted tax upon undistributed profits of corporations. There is now a considerable body of literature directed at the highly refractory problem of a satisfactory method of integrating the taxation of corporate income into a highly progressive system of personal income taxation. There have also been a few articles and studies in the past ten years which have sought to assess the fiscal and economic effects of the 1936 undistributed profits tax or to analyze the merits and defects of that tax as a concrete attempt to solve the problem of integration. That there is such a problem and that it is of a high order of difficulty, few thoughtful students of taxation will be so bold as to deny. But these articles and studies, though some of them were of undoubted worth, have been fragmentary and incomplete or their value has been minimized either by the lack of adequate statistical data or by the use of faulty statistical techniques or questionable assumptions.

The present book is by far the most thorough and careful, as well as best documented, study which has been undertaken of the legislative background and history and the general structure of the undistributed profits tax, as well as of its fiscal and economic implications and consequences. In his analysis of the fiscal and economic effects of the tax, Professor Lent has made full use of the extensive bodies of relevant

statistical data which are now available. These statistical data are organized and made meaningful to the reader by numerous well-conceived tables and charts interspersed throughout the book. The data are broken down both on the basis of classification of taxable corporations by net income brackets and according to the type of activity in which they were predominantly engaged, i.e., manufacturing, trading, mining, agricultural, construction, etc. The methods used afford many interesting and significant analytical and comparative insights. Considerable effort is made also to compare the results within the various classifications in the years 1936 and 1937 with results in years before the enactment and after the virtual repeal of the tax. While the writer of this review speaks with some diffidence in this matter, being neither an economist nor statistician, he feels that Professor Lent has handled this difficult part of his task in a competent and satisfactory manner and has thereby made a contribution of lasting value to the literature in the field.

The material in the book is organized into nine chapters, with a valuable bibliography and an index. The comprehensive scope of the study is indicated by the titles to these chapters: Legislative History of the Taxation of Undistributed Profits, Effect of the Surtax on the Distribution of Corporation Earnings, The Determinants of Dividend Policy, The Impact on Corporation Credit, Tax Avoidance by Use of Non-Cash Dividends, The Role of the Capital Markets, The Effect on Business Growth and Monopoly, The Effect on Economic Stability, and a final excellent chapter containing Summary and Conclusions. The approach to and treatment of the various subjects is admirably objective and free from dogmatism or bias throughout. The book will be disappointing to a reader looking for dogmatic

conclusions or for propaganda for any specific method of solution posited a priori of the problem of integration. Yet the book is not devoid of conclusions formulated as definitely as the nature of the subject matter admits.

At the risk of distortion through undue brevity of statement, it may be said that Professor Lent concludes that the tax as imposed was not a deterrent to monopoly and had some tendency to further concentration of economic power by reason of its hampering effects upon the growth of new or relatively small corporate enterprises by means of tax-free retention of earnings. In the matter of its effects on economic stability, the author concludes that the immediate tendency of this form of tax is probably to intensify the short cyclical swings of business and that its continuance in 1938 in any substantial form would have been a psychological deterrent which might have acted as a brake on the quick recovery from the acute recession of that year. From the point of view of its potential effects on long-run equilibrium, however, the author's conclusions are much more favorable to the tax. He suggests that the statistical evidence and economic analysis support the view that the tax tended to reduce substantially the proportion of national income saved, that such reduction in saving in 1936 and 1937 was probably conducive to a higher level of national income, and that the tendency of the taxation of undistributed profits was to raise the general level of purchasing power and thereby to bring about a better equilibrium of savings with new investment.

The author makes a number of important technical criticisms of the tax as imposed by the Revenue Act of 1936, with the validity of most of which both proponents and enemies of the tax will agree. He suggests that the elimination of these major technical defects in the interests of equity could have made it possible to

strengthen the objectives of the Administration without an undue sacrifice of its principles, and that this would have made the tax much more palatable to the country and might have disarmed much of the hostile criticism directed at it. As to the latter conclusion, the reviewer entertains considerable scepticism. The new method of taxing corporations involved too abrupt a departure from accepted traditions and beliefs and too violent interference with established corporate procedures to have escaped bitter and stubborn opposition in any event.

Contrary to Professor Lent's expressed beliefs (pp. 17,19) that the President's proposal in March, 1936, for the elimination of all corporate taxes save a steeply graduated tax based upon undistributed profits was the product of long and careful study by the Treasury Department and that the proposal had been implemented by a carefully worked out draft of legislation, the fact is that no measure of comparably far-reaching implications and consequences was put forward during the heyday of the New Deal with more scanty and inadequate preparation and study than this.

Most of the defects and inequities in the tax to which Professor Lent justly calls attention were due to one or the other or the combination of three factors: (1) this lack of adequate preliminary study and preparation; (2) the vain effort made by the Conference Committee to compromise and harmonize the basically conflicting premises and philosophies of the House and Senate Bills which resulted in a hybrid measure reflecting largely the weaknesses of both and the virtues of neither; and finally (3) the fact that the Administration proposed the new tax in a form and with a schedule of rates calculated to produce the specific amount of permanent additional revenue which the budgetary situation resulting from the judicial invalidation of the processing taxes seemed to require. In conse-

quence, every proposal made to modify or cushion the application of the tax in the interests of equity was weighed primarily by the Administration forces not on the scales of equity or soundness in point of policy but rather by considerations of its estimated revenue effect. But for this latter fact, many of these technical defects might have been corrected before final enactment of the bill. Obviously, this was a questionable procedure to follow in the enactment of a measure recommended as a long-overdue fiscal reform.

In his appraisal of the tax as a revenue-raising measure, Professor Lent fails to point out the fact of the complete escape from income tax under a pure undistributed profits tax of the substantial segment of corporate profits flowing as dividends into the coffers of various tax-exempt institutions, a net revenue loss which must be made up by additional or higher taxes upon taxable recipients or subjects. It is a well known fact that the additional revenue produced by the 1936 undistributed profits tax was disappointing and ran substantially below the Treasury estimates.

Such defects as there may be in this book, however, seem slight in relation to its many virtues. Professor Lent has produced a compact volume which will well reward study by anyone interested in the problems of income taxation.

ARTHUR H. KENT

San Francisco, California

Opportunities for Economy in County Government in Virginia. Report of the Committee on Taxation and Government of the Virginia State Chamber of Commerce. (Finance Document No. 12.) Richmond: Virginia State Chamber of Commerce, 1947. Pp. xxvi + 77. In paper, \$2.00; in cloth, \$2.50.

This report includes chapters on: governmental structure, county relations to other governmental units, county revenue structure, county organization, and newer plans for county management. Virginia is notable for its relatively small number of independent local government units (323 in 1942) and the consequent simplification of inter-governmental relations. Yet this report concludes: "The comparative benefit which might seem to inhere in the paucity of minor political subdivisions in Virginia is offset substantially because of (a) the extremely small populations found in more than one-half of the counties and (b) the autonomous status of the 24 independent cities within whose borders reside three-tenths of the total population." (p. 68) Per capita operating costs of county government are found to increase consistently as population size decreases. Progress under the Optional Forms Act of 1932, which permits adoption of a county manager plan, has been slow, only three counties having made thoroughgoing reforms.

PLANS FOR THE DENVER CONFERENCE

ARRANGEMENTS for the National Tax Conference, to be held in Denver, Colorado, October 4-7, 1948, inclusive, are well under way. The Local Arrangements Committee, headed by John Seaman, Chairman of the Colorado Tax Commission, has secured ample hotel accommodations and is working to insure a suitable environment for our deliberations including, of course, an interesting and novel program of entertainment for the ladies.

The program this year is under the direction of I. M. Labovitz, of the U. S. Bureau of the Budget. Other members of the Program Committee are: Fred Bennion, Executive Secretary, Colorado Public Expenditure Council; C. Emory Glander, Tax Commissioner, State of Ohio; Elton K. McQuery, Executive Secretary, Colorado Resources and Development Council; M. E. McDowell, Head, Tax Department, Standard Oil of New Jersey; Paul E. Shorb, Attorney, Washington, D. C.; A. E. Patton, Vice-President, Public Service Company of Northern Illinois; and Harvey Willson, Manager of Revenue, City and County of Denver.

The Committee's tentative outline calls for approximately eighteen working sessions about evenly divided between general meetings and round tables. There will be between fifty and seventy-five scheduled participants.

The program will focus major attention on two topics: excise taxation and tax administration and compliance. Several meetings will be devoted to various aspects of these problems as they affect the interests of business and corporate tax representatives and the responsibilities of Federal, state, and local administrators. Other topics tentatively being considered for the program are: issues involved in the taxation of mineral resources; the tax treatment of Federally

owned real estate; the allocation of public utility property; and financial problems of governments serving areas to which there have been substantial influxes of population. Members having an interest in other topics are invited to communicate their suggestions to any member of the Program Committee or the Executive Committee.

The Burlington Railroad has announced that it will operate a special train for the convenience of those attending the Conference from Chicago and the surrounding area. The train will leave Chicago at approximately 1:30 P. M. on Saturday, October 2, arriving in Denver about nine o'clock the following morning. If a sufficient number are traveling by train from New York and New England, additional cars will be operated directly from New York to connect with this special train. United Airlines has also indicated an intention to operate one or more extra sections of its regular schedule or a special flight for the convenience of members in the East and Middle West. These flights will be on Sunday morning, October 3.

Mr. Seaman reports that on Wednesday afternoon it is planned to hold a barbecue and possibly a rodeo near Morrison, Colorado (approximately fifteen miles southwest of Denver). A stop at the Municipal Outdoor Theatre in the Garden of the Red Rocks for a short musical program will be included. After the barbecue the return to Denver will be a circle trip over Lookout Mountain where visitors will have the opportunity to visit Buffalo Bill's grave and museum at the summit of Lookout Mountain.

Denver is one of the three cities of the United States in which a United States mint is located, and we plan arrangements for the ladies to visit the mint. Another

trip for the ladies will be to Central City, which is one of Colorado's noted mining camps, the spot where gold was first discovered in Colorado. While there they will visit the famous old Teller House and Bar, view the "face which appears on the bar room floor," and see some of the old mining shafts in the vicinity. From Central City the caravan will proceed to Idaho Springs for a noon luncheon at the Placer Inn. En route to Central City they will probably see miners panning gold from the bed of the creek and may be given specimens of ore as a memento of the occasion.

Other arrangements are being made for the entertainment of both men and women attending the conference which we believe will be of interest to all who have not had the opportunity of visiting the Rocky Mountain region.

Mr. Seaman suggests that as many of the delegates as possible take advantage of a number of sight-seeing trips following the close of the convention on Thursday. These trips can be made at a reasonable cost. For example, a one-day round trip can be taken through the scenic Rocky Mountain National Park.

If the Trail Ridge Road is still open visitors will have the chance to go to the summit of the Continental Divide at an elevation of 12,000 feet above sea level. If the road is closed we could proceed to the point where snow banks block it. If the road is open we could proceed on down

into Grand Lake, view the Grand Lake Diversion Development, and return to Denver via Berthoud Pass. Should the road be closed we could return from Estes Park via the South St. Vrain road, which would make an ideal circle trip from Denver.

Colorado Springs, which is only seventy-five miles from Denver, would make an ideal week-end trip as there are many interesting places to visit including the Garden of the Gods, Pikes Peak, Manitou Springs, Broadmoor Hotel, and a trip up Cheyenne Mountain to the Will Rogers Shrine as well as the Penrose Zoo which is also located at the base of Cheyenne Mountain.

Mr. Seaman urges all delegates attending the conference to arrange their stay in Colorado so that they may take advantage of the ideal October weather and the colorful mountain scenery. He suggests that fall clothing be brought along as the nights are rather cool in the higher altitudes. Those contemplating driving to the conference need have no fears of snow or bad weather at this season of the year.

The headquarters of the Conference will be in the Cosmopolitan Hotel. Hotel reservations should be made with Clarence N. Hockom, manager of the Denver Convention and Visitors Bureau, Inc., 519 Seventeenth St., Denver 2, Colorado. Hotel rates are listed below. The Brown Palace Hotel is across the street from the Cosmopolitan and the Shirley Savoy is a short block away.

HOTEL RATES PER DAY FOR 1948 NATIONAL TAX CONFERENCE

Accommodations	Cosmopolitan	Brown Palace	Shirley Savoy
Single room	\$4.50-\$ 5.00	\$ 4.50-\$ 8.00	\$2.75-\$3.85
Double room	7.50- 8.00	6.50- 9.00	2.75- 3.85
Twin bed room	7.50- 8.00	7.00- 11.00	4.00- 6.00
Suites:			
Two room	15.00	20.00- 28.00	
Three room	25.00	30.00- 42.00	

Notice of the Annual Meeting of the National Tax Association

Pursuant to the provisions of Section 1 of Article III of the By-laws, notice is hereby given of the annual meeting of the National Tax Association at the Cosmopolitan Hotel, Denver, Colorado, November 7, 1948, at 11 o'clock A. M. Officers, three

regular members of the executive committee, two honorary members of the executive committee, and any additional members required to fill vacancies will be elected at that time.

NEW MEMBERS

CALIFORNIA

- MR. C. BLAIR HUTSON, Valuation Engineer
State Board of Equalization
P.O. Box 1799, Sacramento 8
- MR. C. E. KALLAL, Manager
Tax Department, Sears, Roebuck & Co.
2650 E. Olympic Blvd., Los Angeles 54
- MR. JOHN B. MARSHALL, Statistician
State Board of Equalization
786 5th Avenue, Sacramento 18
- MR. DARRELL R. RYNO, Comptroller
Arden Farms Co.
1900 W. Slauson Avenue, Los Angeles 44

CONNECTICUT

- MR. ALEX F. ARCADY, Tax Accountant
109 Prospect Avenue, Bridgeport
- MR. C. RICHARD GUNZER, CPA
Catamount Road, Westport

FLORIDA

- PROF. WIRT PETERS, CPA
University of Miami
P.O. Box 6251, Coral Gables 34

ILLINOIS

- MR. ROY J. BARNETT, Tax Com'r
Standard Oil Co. of Indiana
910 S. Michigan Avenue, Chicago 80
- MR. JOHN K. LANGUM, Vice-President
Federal Reserve Bank of Chicago
P.O. Box 834, Chicago 90
- MR. LE ROY L. QUALLS
University of Illinois
226 David Kinley Hall, Urbana

MARYLAND

- MR. JOSEPH H. A. ROGAN, Chm.
State Tax Commission
504 Davison Building, Baltimore

MICHIGAN

- MR. ALAN L. GORNICK, Associate Counsel
Ford Motor Company
3000 Schaefer Road, Dearborn

MINNESOTA

- MR. WAITE D. DUFFEE JR., Student
University of Minnesota
1475 N. Cleveland Avenue, St. Paul 8
- MR. M. R. KEITH, Attorney
200-228 Civic Arts Building
Minneapolis 15

NEW YORK

- MR. FRED E. EWING, Asst. Director
Rochester Bureau of Municipal Research, Inc.
45 Exchange Street, Rochester 4
- MR. KRANTZ KELLER, Comptroller
Carrier Corporation
300 S. Geddes Street, Syracuse 1

PENNSYLVANIA

- MR. M. CLYDE SHEAFFER, Attorney
17 N. Front Street, Harrisburg

HAWAII

- MR. ROBERT M. KAMINS
Legislative Reference Bureau, University of Hawaii
P.O. Box 18, Honolulu 10

MEXICO

- SECRETARIA DE HACIENDA Y CREDITO PUBLICO
Comision Ejecutiva de Plan Nacional de Arbitrios
Correo Mayor Num. 31, Mexico, D. F.